S. HRG. 101-1100

ISSUES RELATED TO THE JURISDICTION OF THE COMMODITY FUTURES TRADING COMMISSION AND THE SECURITIES AND EXCHANGE COMMISSION

HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

SECOND SESSION

ON

ISSUES RELATED TO THE JURISDICTION OF THE CFTC AND THE SEC WITH RESPECT TO STOCK-INDEX FUTURES

MAY 8, 1990

Printed for the use of the
Committee on Agriculture, Nutrition, and Forestry

U.S. GOVERNMENT PRINTING OFFICE

36-518 == WASHINGTON : 1990

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

S161-7

26-518 - 91 - 1

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ISSUES RELATED TO THE JURISDICTION OF THE COMMODITY FUTURES TRADING COMMISSION AND THE SECURITIES AND EXCHANGE COMMISSION

TUESDAY, MAY 8, 1990

U.S. SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC.

The committee met, pursuant to notice, at 2:39 p.m., in room 216, Senate Hart Office Building, Hon. Patrick J. Leahy (chairman of the committee) presiding.

Present or submitting a statement: Senators Leahy, Heflin, Fowler, Daschle, Kerrey, Lugar, Cochran, Boschwitz, Bond, and Gorton.

STATEMENT OF HON. PATRICK J. LEAHY, A U.S. SENATOR FROM VERMONT

The CHAIRMAN. We thank the panel, Secretary Glauber and Chairman Breeden, and Chairman Gramm, for being here. Chairman Greenspan, when we changed the time, had run into, initially at least, an irreconcilable conflict and will join us a little later. We discussed that with him, and he is perfectly willing to join up with us a bit later.

Over the past several weeks, there have been recurrent newspaper reports describing the jurisdictional tugging by two agencies—the SEC and the CFTC—over which will regulate stock-index futures.

The political gamesmanship makes for interesting copy, and it makes it very easy for someone writing articles. Unfortunately, it overshadows the much larger and more important issue—cleaning up and restoring confidence in the financial markets.

In the past 2 years, we have seen a "sting" operation raise allegations of widespread fraud in the trading pits, a Government Accounting Office report criticizing audit trail systems, and a soybean emergency exploding in July.

We have seen the indictment of 48 Chicago floor traders and our former colleague, Senator Tom Eagleton of Missouri, quitting the Chicago Mercantile Exchange board to protest insider domination of exchange affairs.

There is no question the system needs fixing. Rules have been ignored; customers have been left unprotected.

Without the public's trust, futures markets cannot function. They cannot serve the needs of our country.

It is for these reasons that last November, this committee unanimously—and I underline unanimously—passed the toughest futures reform package in decades. This legislation, S. 1729, the "Futures Trading Practices Act of 1989," now awaits action on the Senate floor, and is being held hostage by the interagency struggle. This struggle has left market users in limbo. Many feel that jurisdictional tampering only promises weakened regulation, damaged competitiveness, and regulatory chaos.

I have heard Mr. Breeden speak before that the current jurisdictional split between the SEC and the CFTC has created problems in the areas of margin, innovation, or law enforcement. If so, then this committee should consider responsible, appropriate solutions—possibly even the ultimate merger of the SEC and the CFTC if this is shown to be justified and feasible.

But we must also remember that radical surgery can have radical side effects. The cure can be worse than the disease.

I am concerned that stripping the CFTC of jurisdiction piece-by-piece will weaken regulation across-the-board. It could cripple the CFTC's effectiveness and hand over stock-index futures to an agency that does not now have a program or staff in place to police them. It could create years of uncertainty and costly litigation in the process.

But more important, I am concerned that now—almost 16 months since the disclosure of the FBI Chicago "sting" operation and with the resulting criminal trials opening this week in Chicago courtrooms—Congress remains blocked from enacting the tough reforms we all agree are needed.

Seven weeks ago, Senator Lugar and I wrote to Secretary Brady asking his support to move S. 1729, the futures reform bill, to the Senate floor separately from the issue of jurisdiction. The reason we did this is because Secretary Brady previously had given this type of green light to S. 648 [Market Reform Act of 1989], the stock market reform bill reported by the Senate Banking Committee.

Senator Lugar and I did this because we felt that the futures reform bill should be treated in the same manner as the stock market reform bill. The integrity of the crude oil, currency, Treasury bond, agriculture and metals futures markets is just as important as integrity on Wall Street.

About an hour ago—and for me about 5 minutes ago—we finally heard back from Secretary Brady, who now wants to use S. 1729 to shift jurisdiction from the CFTC to the SEC. This will have the most radical side effect of all—the sentencing of the futures reform bill to a state of legislative limbo, complete with parliamentary holds and filibusters. It is a nice letter. It guarantees nothing will be done.

I am sensitive to the issue raised by the SEC and Treasury and the arguments on both sides. But we already have a consensus as to what needs to be done to clean up the futures industry. Let us not slow that down while we study and debate the highly complex and divisive issue of jurisdiction. This is something that could keep us all happily engaged well until after the Congress adjourns for the year.

We all need to work together on this. Fighting and pressing media hot-buttons will only make this difficult issue tougher to resolve.

I read Chairman Breeden's statement in Saturday's New York Times that there were "disturbing parallels" between the debate over stock-index futures jurisdiction and the savings and loan crisis—now, in Vermont we tend to use our words carefully—and was frankly startled by this escalation of rhetoric. I thought maybe, as a Vermonter, I might not understand the different type of language used down here in the big city.

If Chairman Breeden has evidence that anyone in Chicago is pilfering funds at levels of $200 to $300 *billion* that may have to be repaid from taxpayers' pockets, then I hope he has relayed this information to the FBI--because that would be a disturbing parallel with the savings and loans crisis. The comparison between "interest groups" opposed to jurisdictional changes—which happens to include virtually all farm producer organizations—with fraudulent thrift operators is perplexing.

I am not really able, in my experience, to compare the farm producer organizations with the fraudulent thrift operators. In fact, I might say, Chairman Breeden, if you have evidence of such massive fraud, then bring it forth. But if not, try to relate your rhetoric to the facts, because in Government that is not a luxury, it is a duty.

The SEC's own record in the savings and loan affair is not spotless. I will put in the hearing record an article from the April 16, 1990, issue of "Barron's" titled, "What Investors Never Knew," which recites the SEC's failure to warn customers about known risks associated with Mr. Charles Keating.

For today's hearing, I hope all sides will keep the hot rhetoric in their briefcases. We have serious work to do, and talking about the savings and loan crisis or regulatory imperialism is not very helpful to the problem at hand.

Now, we have a distinguished panel of witnesses. We look forward to the testimony of all four of you.

Before we begin, I will put in the record three letters we have received on this issue: one from Susan Bryant, the president of the North American Securities Administrators Association, urging quick enactment of S. 1729 without amendment; one from the American Farm Bureau Federation opposing shifts in jurisdiction away from the CFTC; and one from Robert Mackay, Virginia Polytechnic Institute and State University on how academic research fails to show a relationship between margin levels and volatility.

[The Barron's article, "What Investors Never Knew" and the letters referred to follow:]

Barron's
April 16, 1990

What Investors Never Knew

Ugly Facts About Charles Keating Were Not Disclosed

By BENJAMIN J. STEIN

THERE he goes again. The Banquo's Ghost of the S&L catastrophe, Charles H. Keating Jr., former nationally rated swimmer and savings and loan mogul/destroyer, has recently put in an appearance at a Senate Banking Committee hearing in Washington, D.C., where he tried to press a petition upon his former friends on the committee, notably Don Riegle, then stared fixedly at men who used to gladly take his money and now ignored him. Despite his being spurned by his erstwhile beneficiaries, afterwards, in the halls of Congress, Keating gave onlookers some points on the real cause of the S&L disaster. The cause, he explained for the millionth time, was the federal government's harassment of innocent, hard-working S&L barons like himself. Again, there is no sign that Don Riegle or Sens. Cranston, McCain, Glenn or De Concini stayed to listen.

And just last week, testifying at the trial in which he is suing the federal government, accusing it of illegally seizing his Lincoln S&L just when he was about to put it to rights, Keating again expounded on his victimization. He was the totally blameless victim of a government that deregulated thrifts, but then had no idea of how to deal with the imaginative, innovative ways that guys like Keating had of running their thrifts.

Never mind the intricate scams in which Lincoln bought land from itself through dummies to boost its profits. Never mind the wild self-dealing in stocks and real estate. Never mind the money sucked out of the S&L (and the taxpayers) and given to Keating and his family. No, to Charles Keating, these are federal inventions to frame the innocent S&L executive, Charles Keating, himself.

It's an interesting defense, that offense-defense play, and you have to give Keating credit for audacity and energy. And, in a way, his defense fits nicely with the defense of the Keating Five, who say that as far as *they* knew, Keating was always a stand-up guy, just another hard-working businessman trying to meet a payroll with his family on it, and how were they to know his money had a slight odor attached to it?

But historical facts of who Charles Keating is are even more interesting. They tell a tale of a man who, like most of us, works in a pattern—but his is of misconduct to stockholders and towards federally insured deposits. The tale is of a man whose past should have given a clear warning to government officials in all branches of government long before he bought Lincoln. They also tell a sadly haunting story of a government that simply failed in its most basic duties to protect investors by making available to them basic truths about who is handling their money.

Benjamin J. Stein is a writer, lawyer and economist.

Taking one of a number of possible approaches to the sad story, one might begin in 1979. In that year, Charles H. Keating Jr. had begun and more than begun his American Continental Corp. in Arizona. He was merrily building huge developments out of former desert. He had not yet bought Lincoln Savings & Loan.

But in that year, on July 2, 1979, the Securities and Exchange Commission came out with a complaint against Keating, the legendary financier Carl Lindner, Lindner's vehicle, American Financial Corp., and a former Keating law partner, Donald P. Klekamp.

The complaint noted that from 1972 to 1976, Keating was executive vice president of AFC, and was a director of AFC from 1962 to 1976. (Keating was also a lawyer for, and close confidant of, Lindner from at least 1958.)

As these things are measured in the current era, the sums involved in the 1979 complaint against Keating, Lindner, AFC and Klekamp were small. Not one of the allegations concerns amounts greater than $14 million.

But the kind and type of the wrongs alleged against Keating were and are ponderable. AFC had a number of financial institution subsidiaries. One of them was a bank in Cincinnati called Provident. Another was a bank holding company called United Dairy Farmers Investment Co. Another was a leasing company called American Financial Leasing Service.

The SEC charged, first of all, that Keating and Lindner caused Provident to make loans to a whole collection of Keating associates on wildly preferential terms. These included not requiring credit applications, not requiring regular payments on the loans, making new loans to cover delinquent older loans, indirectly guaranteeing loans to the Keating group from other entities, and allowing officers and affiliates of Provident to personally guarantee loans from Provident on terms that would absolutely not have been available to other borrowers. By far the largest borrower in this group was Keating himself. On a salary of about $200,000, Keating allowed Provident to lend him about $4.5 million, largely unsecured.

In other words, one of the main SEC complaints against Keating was that he had used a federally insured bank essentially as a self-controlled piggy bank for his own purposes, had caused it to grant loans to him on terms that would generally have been considered unsound, and had covered up problems with those practices by giving himself still more loans. The SEC said that because this was not disclosed to stockholders of AFC, there were violations of a number of basic SEC disclosure rules.

The SEC also charged in 1979 that Keating had facilitated a series of loans to his former law partner, Klekamp, which were secured by stock in AFC. When the price of AFC stock declined, Keating caused AFC to basically rescind the whole transaction and to simply write off the amount, about $500,000, by which the loans exceeded the value of the AFC stock collateral. Meanwhile, AFC had reported to its stockholders a far smaller loss on the deal of about $250,000. AFC had also reported that the loans had been evidenced by a promissory note, which was not true.

The money for the transaction had come from the leasing subsidiary, American Financial Leasing Service, but it had passed through Provident Bank.

The SEC complained, once again, that a series of fraudulent statements had been made, and that they involved the misuse of a federally insured savings bank. They also involved the misuse of a public company for the benefit of insiders and their pals at the direct expense of stockholders.

A third SEC complaint was about another bank owned by AFC called Athens National Bank. The SEC noted that Keating and Lindner had caused ANB to make substantial loans that were unsecured and lacked credit applications. When Lindner sold ANB to First Banc Group of Ohio, regulators questioned the loans. Lindner agreed to have AFLS and Provident assume those loans even though AFLS was not a lending institution, even though there still were no credit histories on the borrowers, even though there were still not even any plans to repay those loans on file at AFC or anywhere else. This decision was taken without consultation by Provident's board of directors.

Keating and Lindner did not disclose to AFC stockholders the bizarre terms of

Continued

these transactions, and in fact said that the transactions were in the ordinary course of business.

Yet again, the SEC especially had complained about the misuse of a federally insured bank to benefit insiders, at the behest of Keating and Lindner.

There was also an SEC allegation that Lindner had personally taken a part of the gain on an airplane that was owned by AFC when the craft was sold. And the commission alleged that relatives of two AFC players had engaged in a securities swap in which the value of the securities in question had been substantially misstated to benefit the relatives of insiders.

One of the most fascinating allegations by the SEC in the 1979 complaint was that Lindner and Keating wished to sell a bank subsidiary of AFC. In order to do so, they caused Provident, another bank subsidiary of AFC, to lend money to the purchasers. When the purchasers could not make the loan payments, Provident was caused to make more loans. When the purchasers failed to make payments on those loans, Provident was caused to make still more loans.

When the purchasers got a loan from Continental Illinois Bank and defaulted on that loan, Lindner and Keating bought that loan from Continental.

When all of this happened and the buyers were in default on every loan they had gotten to buy the bank, Keating and Lindner made still another loan to them. This, apparently, was eventually paid.

The SEC complaint noted that the extraordinary nature of these transactions had not been revealed in AFC filings, and rather that they had been described as normal loan transactions. In other words, the SEC alleged that Keating and Lindner had been using the funds of a federally insured bank they controlled to make risky loans to help them sell an asset of the parent company.

In yet another complained-of transaction, Keating and Lindner caused Provident to buy back a bad loan from another bank if, in return, that bank would lend about $600,000 to Keating. In turn, that money was used to pay off part of the debt that Keating owed at Provident. Or, to put it another way, Keating put insured deposits of Provident at risk in order to secure a personal benefit for himself. This also was not disclosed to stockholders.

In 1975, Keating obtained a loan of about $400,000 from the Royal Bank of Canada. He caused Provident to guarantee the loan and interest without disclosing it to stockholders. Again, this was misuse of a federally insured bank for the benefit of an officer and director of that bank.

All in all, the SEC complaint alleged serious wrongdoing by Keating and others in the management of a federally insured bank, and failure to disclose the questionable nature of the transactions. The common thread of the transactions was a skein of fraud, self-dealing, and use of Provident assets to generate phony or highly questionable transactions to make AFC look better or to enrich Keating, Lindner and others.

Simultaneously with the filing of the complaint by the SEC, Lindner and Keating "consented" to the charges. Lindner paid back to AFC about $1.4 million. Keating paid back no money, but did formally agree not to do any more violations of the federal securities laws and to refrain from denying that he was in fact guilty of the charges (and was allowed also to not admit them).

By any conceivable standard, in other words, the SEC knew, actually had in its files, unequivocal evidence that Charles H. Keating Jr., whatever fine qualities he might have in other fields, was a highly dicey man to have around a federally insured S&L, or any financial institution.

Yet in 1983 and '84, Michael Milken and his Drexel Burnham Lambert sold about $150 million in "junk" bonds for Keating's personal corporate vehicle (which also had about three million shares outstanding).

Nowhere in the prospectus for those bonds is there any unequivocal mention of Keating's problems with federally insured funds and his consent to the SEC's complaint in 1979, even though $50 million of the sum raised by Drexel was to be used to buy Lincoln.

This gets worse. When Keating made application to buy Lincoln, he was asked if he would solemnly promise to maintain the thrift as primarily a lender to families for the purchase of homes. He solemnly agreed to do so. In the first year after he took over the thrift, he made a grand total of exactly 11 home mortgage loans, at least four of them to officials of Keating's parent company, American Continental. The Federal Home Loan Bank Board therefore knew, from Day One of Year Two, that Keating was not keeping his most basic promises to them.

Further, Keating, after long negotiation with the Bank Board, was allowed to have a tax-sharing arrangement between ACC and Lincoln. Under that deal, Lincoln was allowed to "upstream" payments to ACC, Lincoln's parent, for tax liability actually due on Lincoln earnings. There were strict limits on the payments so allowed, because (obviously) unscrupulous persons could use phony payments under such a plan to simply drain money out of the S&L and pay it to the parent.

One of those conditions was that ACC would not get paid anything under the plan for Lincoln's deferred tax liability. Yet soon after the plan went into effect, Keating caused Lincoln to pay to ACC almost $100 million to cover deferred tax liability. This money was never paid to the IRS.

The Bank Board knew about this problem from 1985. Yet it was never disclosed to investors or to markets generally in SEC filings.

Other parts of the tax-sharing plan called for payments only on real gains and only when actually due to the IRS. Yet over the years 1984 to 1987, Keating caused payments of hundreds of millions of dollars for supposed tax liability from Lincoln to ACC on totally sham transactions.

In these transactions, typically Lincoln or an affiliate would buy a piece of property. Keating would then arrange for a sale to another buyer at a huge advance in price. The funds for the purchase, directly or indirectly, would come from Lincoln. The buyers would default, and Lincoln would eventually take back the properties. But a large gain would be reported for purposes of showing a profit at Lincoln, upstreaming cash to ACC, and making ACC seem successful.

From at least 1987 onward, and probably from 1985, staffers and at least some higher-ups at the Bank Board knew for a fact that Lincoln was being run in a highly unethical way, that its management was misusing it for the benefit of management's parent company, and that Lincoln was probably insolvent. From mid-1987 onward, the Bank Board knew for a fact that Lincoln was being run in an almost completely dishonest way, that its management was looting it for the benefit of the management's parent company, and that Lincoln was in fact insolvent. From mid-1987 onward, the Bank Board and various officials at the White House had been notified that Lincoln was probably broke and definitely operating extremely unsafely. Those officials were in daily contact with the SEC in formal and informal contexts.

This was revealed in documents in great detail. These documents were at least available to the major economic-policy officials in the Reagan Administration, especially to Donald Regan, White House chief of staff at the time.

Even so, even as ACC was issuing 10Ks and 10Qs to keep markets advised of its situation, no one in government

Continued

thought it necessary to tell stockholders or bondholders one word about the evident fact that Keating, a man who had agreed never to deny that he had misused and abused a federally insured bank in a formal SEC proceeding, was quite clearly doing precisely the same thing at a far larger savings institution on an incomparably larger scale.

That is, no one at the SEC deemed it necessary to tell markets that a known abuser of savings institutions was apparently doing it again.

With full evidence of just what kind of trustee Keating was in its files, with the whole federal government bursting with data that he was doing the precise same kinds of transactions again—using federally insured assets for his benefit, engaging in sham transactions, running Lincoln into disintegration—the Securities and Exchange Commission did not require ACC to give even a hint of the problems from 1984 onwards in its "disclosure" documents.

To read the 1979 SEC complaint against Keating and Lindner, and then the 131-page 1989 federal civil complaint against Keating is disconcerting. The outlines of the deals are identical. Yet, with the complaint of 1979 on file, the instantaneous ability to see the same footprints all around Lincoln, the SEC did nothing whatsoever to meaningfully inform investors, relying on a technicality about time limitations on disclosures.

In 1986 and 1987, ACC filed with the SEC for the sale of $25 million of debentures, as well as for the sale of another $25 million of debentures, and filed registration statements for $200 million of debentures, for a secondary sale by Keating and associates of 100,000 shares of ACC, and the regular quarterly and yearly filings mandated of a public company.

Despite what the SEC knew, that agency did not require one word in any of those documents about Keating's history before the SEC, his problems with ethical issues while running Provident Bank, the vast array of complaints about Keating's practices at Lincoln, or the practical knowledge that Lincoln, ACC's largest division, was insolvent. The SEC did not require one word be told to the investment community about these things for at least four years.

An issue of about $220 million of subordinated, now largely worthless, paper was sold over the counter to depositors at Lincoln branches with handout prospectuses. There was not one syllable in those prospectuses about Keating's problems with the SEC in 1979, despite their place in the SEC files, and not one word about the catastrophe that had occurred at Lincoln, even though that disaster was well known within the government—and had been publicly reported in an Arizona magazine in the summer of 1987.

The federal securities-regulation plan is based upon the prophylax of full disclosure to investors. Armed with full knowledge of any relevant fact an investor might need to guide his investing decisions, that investor is allowed to make his own decisions. But—and this is a big but—the system depends upon full disclosure. At the barest possible minimum, the SEC is supposed to insure that full disclosure. Even if it can't do anything else, the staff and commission are supposed to make sure investors know what's important.

Yet investors were sold over $200 million of debt instruments that are now worthless, and traded in about $30 million of equity issues that are now worthless, without the SEC's requiring that they be told the most basic facts already in SEC hands about the issuer. To this day the SEC has still not issued a complaint about any Keating-Lincoln omission or lie at all.

I would like to offer a fundamental theorem about securities law: There is no securities law without enforcement of the securities law. Yet in the case of ACC, and in every other case I have studied, the SEC simply does not enforce the laws on the books. This fools investors, makes them think they are protected when they are not; and makes life much easier for crooks. In a word, the kind of failure at law enforcement one sees in ACC/Keating means there is a real question as to whether investors can count on minimum federal law protection.

This is not a small thing. It is a major blow against the free market system. Keating's story is extremely worrisome for investors and for fans of the market generally. ■

NASAA

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May 4, 1990

The Honorable Patrick Leahy
Chairman
Committee on Agriculture, Nutrition
and Forestry
U.S. Senate
328A Russell Senate Office Building
Washington, D.C. 20510

RE: S. 1729, the Futures Trading Practices Act

Dear Mr. Chairman:

On behalf of the North American Securities Administrators Association[1], I respectfully urge that S. 1729, the "Futures Trading Practices Act of 1989," be brought as quickly as possible to the floor for adoption without amendment by the full Senate. The widespread fraud and manipulation uncovered by the recent federal investigation into Chicago's commodity futures markets has raised critical questions concerning the integrity of the futures trading process and its regulation. The reforms included in S. 1729 would help restore integrity to the commodities markets and enhance investor confidence in their operations and fairness.

Enclosed is a copy of a resolution that was adopted without dissent by the members of NASAA at our meeting last week in Washington, D.C., urging the immediate enactment of S. 1729. This resolution indicates the sentiment of state securities administrators that adoption of this comprehensive legislative package is of vital importance.

While questions concerning margin levels, the appropriate regulatory jurisdiction of stock-index futures and a possible

[1] NASAA is the association of the state, provincial and territorial securities administrators of the United States, Canada and Mexico. In the U.S., NASAA is the national voice of the 50 state agencies responsible for the protection of investors and the efficient functioning of the capital markets at the grassroots level.

President: Susan E. Bryant (Oklahoma) • President-Elect: M. Douglas Mays (Kansas) • Secretary: Merrill H. Wigginton (Prince Edward Island)
Treasurer: Elton L. Brown (Maryland) • Directors: John C. Baldwin (Utah), Christine W. Bender (California), Stephen L. Diamond (Maine),
John F. Mann (New Mexico) and Ralph A. Lambiase (Connecticut) • Executive Director: Lee Polson

merger of the Securities and Exchange Commission (SEC) and the CFTC are indeed very important, these issues will require careful, thoughtful and deliberate study. It will likely be some time before there is agreement on how to resolve such complex public policy questions. Investors should not, however, be forced to continue to suffer the consequences while these issues are debated. Investor protection measures must be taken now to clean up the futures pits. NASAA respectfully urges the immediate adoption of the Futures Trading Practices Act without amendment by the full Senate. The larger policy issues can then be considered in a deliberate and careful manner not pressured by the sense of urgency to reform the regulatory structure of the commodities markets. I would finally note, however, that NASAA has not made any judgment on jurisdictional issues and does not by its resolution intend to comment at this time on the ultimate disposition of those issues.

Sincerely,

Susan E. Bryant

Susan E. Bryant
President

cc: Members, Senate Committee on Agriculture, Nutrition and Forestry

NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

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April 28, 1990

RESOLUTION OF THE MEMBERSHIP OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC., REGARDING S. 1729, THE FUTURES TRADING PRACTICES ACT OF 1989

WHEREAS, on November 2, 1989, the Agriculture Committee of the United States Senate favorably reported S. 1729, the Futures Trading Practices Act of 1989, to the floor of the Senate for consideration; and

WHEREAS, S. 1729 contains numerous reforms to the federal Commodity Exchange Act, including enhancement of the enforcement authority and resources of the Commodity Futures Trading Commission, which have been mandated by experience, the recent history of reported illegal conduct, and the necessity of preserving confidence in and the fairness of the American marketplace for futures trading; and

WHEREAS, the need for these reforms is immediate, and their consideration and enactment will be delayed indefinitely if coupled with proposals to consider more controversial and fundamental issues of jurisdiction;

NOW THEREFORE, BE IT RESOLVED, that the North American Securities Administrators Association, Inc., endorses S. 1729, the Futures Trading Practices Act of 1989, as adopted by the Agriculture Committee of the United States Senate on November 2, 1989, and urges its immediate enactment without further amendment.

Adopted by the membership of the North American Securities Administrators Association, Inc., at its spring meeting in Washington, D.C., on April 28, 1990.

President: Susan E. Bryant (Oklahoma) • President-Elect: M. Douglas Mays (Kansas) • Secretary: Merrill H. Wiggin (Prince Edward Island)
Treasurer: Ellen L. Brown (Maryland) • Directors: John C. Baldwin (Utah), Christine W. Bender (California), Stephen T. Diamond (Maine),
John B. Hart (New Mexico) and Ralph A. Lambiase (Connecticut) • Executive Director: Lee Peloza

AMERICAN FARM BUREAU FEDERATION
225 TOUHY AVENUE · PARK RIDGE · ILLINOIS · 60068 · (312) 399-5700
600 MARYLAND AVENUE S.W. · SUITE 800 · WASHINGTON, D.C. · 20024 · (202) 484-3600

May 4, 1990

The Honorable Patrick Leahy, Chairman
Senate Agriculture, Nutrition and Forestry Committee
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Early in April the American Farm Bureau Federation sent a letter to President Bush and all the members of Congress regarding the importance of Commodity Futures Trading Commission (CFTC) oversight in futures markets. We are pleased that you are holding hearings on this subject. Maintaining CFTC oversight of futures markets and Senate Agriculture Committee jurisdiction in this area is vitally important. Farm Bureau appreciates your strong leadership on this vital issue.

I am enclosing a copy of our letter of April 6, 1990. Please make this letter a part of the hearing record.

Sincerely,

John C. Datt
Executive Director
Washington Office

JCD/jb
Enclosure
cc: Committee Members

Individually addressed to all Members of the House of Representatives

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600 MARYLAND AVENUE S.W. • SUITE 800 • WASHINGTON, D.C. • 20024 • (202) 484-3600

April 6, 1990

Mr. President
The White House
Washington, D.C. 20500

Dear Mr. President:

The American Farm Bureau Federation (AFbF) would like to submit comments regarding the current discussions of the role of the Commodity Futures Trading Commission (CFTC). AFBF was actively involved in the process in 1974 when Congress created the CFTC. AFBF strongly believed then and continues to believe that CFTC regulation of agricultural futures and options trading is an essential element of a mechanism to market farm commodities.

Farmers routinely face two distinct types of risk exposure. These are yield risk and price risk. Weather is the predominant component of yield risk and is largely beyond the control of the farmer. Although a good yield is an essential element of a price and quantity relationship that produces an adequate total revenue, it is clearly not enough. Quite simply, a great year farming can be wiped out by a poor day of marketing.

Farmers are essentially price takers. As individuals, they have limited control over the price they receive. The commodity futures markets offer farmers an opportunity to price their crops and livestock up to a year or more in advance of the time they will be physically marketed. Futures contracts are the driving force of price risk management. When a farmer enters into a forward contract with a local grain dealer or elevator, the ability of that enterprise to offer a forward contract is dependent on the ability to transfer this risk to someone through a futures contract.

Futures contracts must be designed to meet the needs of farmers and must be based on a clear understanding of production factors, cash markets and producer needs. Agricultural input and oversight, as guaranteed by CFTC regulation, and review by the agricultural committees in Congress is essential. Diluting or eliminating CFTC authority would threaten the long-term availability of an essential agricultural risk management tool.

The current discussion of the differing margin requirements between stocks and commodity futures contracts indicates that many of those involved in the debate are unaware of the nature of farm producers' use of futures contracts. Forcing commodity hedgers to put up additional margin requirements would increase the cost of farmer hedging. Without the agricultural expertise within the agricultural oversight committees in Congress and in the CFTC itself, there will be no framework to insure that proposals like increased margins for commodity futures are properly evaluated.

Other futures markets currently surpass the commodity futures in terms of volume. While it would be easy through a reorganization to create a situation where size determines emphasis, commodity futures markets remain an essential component of modern agriculture. Their size relative to other markets is not important to producers who depend on hedging techniques to transfer price risk. Commodity futures market regulation by CFTC includes oversight by the Agricultural Advisory Committee and analysis by staff agricultural economists. The commitment at CFTC is for workable, responsive commodity futures markets regardless of the relative volumes of trading activity. Separating the authority over commodity and financial futures markets would isolate CFTC and undoubtedly dilute the expertise they currently have. If the regulation of financial futures is deemed inadequate, CFTC resources should be expanded. Any attempts to lessen CFTC authority and credibility will diminish the use and effectiveness of futures markets for agricultural producers.

The American Farm Bureau Federation has always supported efforts to improve the CFTC. However, as we did in 1974, we strongly support effective regulatory authority by CFTC. Commodity futures markets are unique markets based on the supply of and demand for physical commodities. Regulation of these markets must be by an agency that has expertise in agriculture.

Sincerely,

Dean Kleckner

Dean R. Kleckner
President

DRK/jb

VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY

CENTER FOR STUDY OF FUTURES AND OPTIONS MARKETS
NORTHERN VIRGINIA GRADUATE CENTER
703 [illegible]

May 4, 1990

The Honorable Patrick J. Leahy
Chairman
Committee on Agriculture
United States Senate
SR-328A Russell Senate
Office Building
Washington, DC 20510-6000

Dear Senator Leahy:

As you begin hearings on issues related to the jurisdiction of the C.F.T.C. and S.E.C., I thought you and the Committee might find the results of a recent review of the academic and scientific literature on margins and market volatility of interest. Over sixty-five published and unpublished papers dealing with margins on stocks and futures were surveyed. Thirty-six of these papers contained substantive empirical or theoretical results on the relation between margins and volatility. On the basis of this extensive review, the author concludes that:

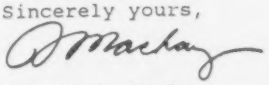
> "Recent calls for changes in the regulatory structure and possible increases in the level of futures margins present significant threats to the viability and economic value of not only these instruments but also to stock and bond markets themselves. Movements in the direction of tighter regulation of margins and higher margin levels are based upon a misguided belief that margins are effective in controlling volatility. Nothing could be further from the truth. The evidence that supports the alternative hypothesis that margin requirements cannot be used to control volatility is simply overwhelming."

The review was conducted by Dr. Don M. Chance, Professor of Finance and Associate Director of the Center for Study of Futures and Options Markets in the Pamplin College of Business at Virginia Polytechnic Institute and State University. Professor Chance is one of the leading scholars in the country on futures and options markets and is the author of the award winning text An Introduction to Options and Futures. His survey is the most recent and comprehensive review of the existing research on margins and volatility.

2990 Telestar Court, Falls Church, Virginia 22041-1287

The attached exhibits provide a capsule summary of the review and abstracts of the existing literature. I would be glad to provide you with copies of the complete study if you wish to receive them. If the Center for Study of Futures and Options Markets can be of any further assistance to you and the Committee in your deliberations please feel free to contact us.

Sincerely yours,



Robert J. Mackay
Professor of Finance and
Director

The CHAIRMAN. I yield to the distinguished Senator from Indiana.

STATEMENT OF HON. RICHARD G. LUGAR, A U.S. SENATOR FROM INDIANA

Senator LUGAR. Thank you very much, Mr. Chairman.

The importance of this hearing cannot be overemphasized, and I commend you for assembling this distinguished panel.

Legislation to provide much-needed regulatory reform in the futures markets has languished for more than 6 months as a result of interagency dispute over which agency should have jurisdiction to regulate certain aspects of futures trading.

I believe it is critical we resolve this dispute in order to move forward with the needed reform provided in S. 1729. The first trials resulting from the Chicago sting operation began yesterday. However, our efforts to provide new regulatory tools to enhance that trade surveillance and monitoring activities remain on hold. As we can conclude from press accounts of this interagency battle, the actions are spirited.

Some journals liken the current dispute to a hostile takeover. Last week, as you have mentioned, Mr. Chairman, SEC Chairman Richard Breeden claimed there was a close analogy between this issue and the savings and loans crisis, and perhaps this hearing will illuminate evidence to substantiate those allegations.

Previously, accusations of "regulatory imperialism" have been levied by those of a differing view. It seems to me that an inordinate amount of time has been spent trying to persuade the press that one position is more correct than another. And in the midst of this dispute, two important reform bills—one of the SEC and one for the CFTC—remain in limbo. Proposals on jurisdiction run the gamut from no action to a wholesale merging of what are now two independent agencies.

At this point, I do not find the evidence compelling with regard to any of these proposals. I do question, however, the wisdom of taking any action as an intermediate measure. If a problem exists with regard to regulatory authority, then a comprehensive solution should be fashioned. This committee has attempted to address all situations in a comprehensive manner, and this issue should not be treated any differently.

Mr. Chairman, I hope that the information we receive in this hearing will enable this committee to deal with the current jurisdictional issue and then, hopefully, to move swiftly to the floor to pass futures reform legislation.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

I would note for my colleagues I am ready to enter into a restricted and short time agreement at any point to move the CFTC reform bill. I think it is the toughest CFTC bill that I have seen in my 16 years here in the Senate, and I have told the Majority Leader and others that I am prepared to move forward with it any time under as short a time agreement as can be entered into.

Does anybody else wish to say anything before we start with our witnesses?

Senator Gorton.

STATEMENT OF HON. SLADE GORTON, A U.S. SENATOR FROM WASHINGTON

Senator GORTON. Mr. Chairman, as the author of the amendment which is pending in the Senate to the CFTC authorization bill and as an obvious minority on this committee, though I suspect not on the floor of the Senate, I think it's appropriate to make a few opening remarks.

The amendment on the floor of the Senate is not the result of a jurisdictional squabble between the Commodity Futures Trading Commission and the SEC. That amendment was placed on the floor by this Senator with a view toward the proposition that it represented a vitally, though completely unaddressed, subject in connection with last year's CFTC hearing, one which was simply not addressed in any of the hearings on that subject.

I began my examination of the CFTC without any opinions one way or another on the subject. I have been led increasingly and, I think, inevitably to the position that without the slightest degree of criticism of either of those regulatory agencies that an inherent instability was present in American markets by reason of a divided authority over two kinds of securities, commodities, whatever we wished to call them, which were so closely and carefully intertwined during a period of time during which I was not in the Senate.

Now, Secretary Brady examined very carefully and very thoroughly the causes of the stock market crash of October 19, 1987. In addition to the additional drop of about a week after that, there have been two significant drops since that period of time. I despair in a sense of dealing with this proposition perhaps until another such crash has taken place or perhaps one after that, the point at which the Congress will be willing to deal with this question.

This CFTC reauthorization bill has not—I repeat not—been blocked by the proponents of this amendment. I was willing in November, and remain willing, at any time to enter into a time agreement under which it is debated on the floor of the Senate and voted on one way or another. It seems to me that we are dealing with an important enough issue so that the Senate and the House of Representatives should be willing to debate it.

The administration has now taken a firm and strong position on the subject. We have in front of us four witnesses. I must say, without deprecating them to any degree at all, in a sense I am a little frustrated at this late date at the narrowness of the testimony we are receiving. Two of our witnesses have an obvious institutional bias in favor of one position or another, as they have the two institutions which are affected by the amendment. The others are more neutral members of the administration and of an independent agency.

I had hoped—I asked last year and I continue to ask—that we might have some outside academic experts on the subject speak to a subject which is highly complex in nature, the precise answer to which I am not sure is held by any Member of Congress.

But the obvious desirability, it seems to this Senator, of coordinating and seeing to it that a single agency provides consistent regulations with respect to two so important a set of impacts on capital formation and the future of the financial system of the United States seems to me to have become more obvious rather than less obvious during the course of the 6 months of debate on this subject.

I simply repeat that it seems to me that it is time that the subject was debated, and I would urge the chairman and ranking members of this committee to see to it that it is debated on the floor of the U.S. Senate. If someone intends to filibuster the bill, let's find out who those filibusterers are. Otherwise, let's vote on something which is very important. Let each Member of the Senate determine whether or not he or she wishes to continue a system which has at least been coincidental with four very, very serious drops in our stock market in the course of less than a 3-year period of time, and wishes to do so in the future.

I think from the point of view of this committee, which after all is primarily the Agriculture Committee, we would have a stronger, and not a weaker, CFTC if it were required to spend more of its time on the agricultural and other commodities it was designed to regulate in the first place, than it does with the tail wagging the dog and with so much of its attention being focused on something that wasn't even invented or thought of at the time at which the CFTC was originally created.

I am happy that we are having this hearing, Mr. Chairman. But a hearing doesn't decide the question. Only Senators voting on the question can and will do that.

The CHAIRMAN. The prepared statement of Senator Dole will be received and inserted in the hearing record.

[The prepared statement of Senator Dole follows:]

PREPARED STATEMENT OF HON. ROBERT DOLE, A U.S. SENATOR FROM KANSAS

Mr. Chairman, I would like to welcome the financial regulation "gang of four" to the Agriculture Committee today. I understand that this ensemble act usually plays before our colleagues on the Banking Committee.

The issues we're here to discuss today are not perfectly understood even by those who make a career of them, let alone by the general public. Yet there's been a great deal of publicity—more like a public relations campaign—in the newspapers. It's been all about who's up, who's down, who's winning the regulatory "turf wars." Frankly, I don't think that's helped.

Because the issue *is* important, and it's *not* about who's winning some power struggle. It's about the integrity of our financial markets. It's about our ability to provide capital and liquidity with sufficient efficiency to make American markets more attractive than the increasingly numerous—and increasingly competitive—alternatives.

And, for those of us on *this* committee, it's about assuring an orderly and fair market, with honest price discovery, for ag products and their derivatives. There's no doubt that that requires in turn a strong and politically credible enforcement agency—one that knows the business.

So the question we're really addressing is whether the proposals to transfer regulatory jurisdiction will advance those goals.

I've spoken with Secretary Brady about these issues. He's very concerned with the volatility that the financial markets have shown on several pretty dramatic occasions in the last 2 years. Faith in our financial stability was shaken. He's right to be concerned.

But it's not clear that the current regulatory system caused or exacerbated that problem, or that enacting this jurisdiction transfer would solve it. It seems to me that a lot of factors are involved, and we need to specify which we are trying to address, and why a transfer necessarily is the answer.

Frequently cited as a source of this volatility is the differing margin requirements for stock-index futures and the underlying equities. The problem is: one, it hasn't been shown that disparate margins increase volatility; or two, that transferring oversight would result in similar margins; or three, that similar margins work as a solution.

In fact, one of our witnesses today, Chairman Greenspan, said in his testimony before our colleagues on the Banking Committee that, after many studies of the matter, *"all of the analytical tools we have brought to bear fail to find any relationship between margin levels and volatility"* (March 29, 1990).

So it seems to me we should be pretty sure that we understand the problem, before we leap on one solution, maybe just to create an impression that we're doing something.

I'm more immediately concerned about the fate of the CFTC reauthorization bill. The CFTC has been doing a pretty good job so far with limited resources. It needs our support. This committee reported out a reauthorization bill last fall, yet to see floor consideration, which would strengthen those resources. It's a good, tough bill. I'd like to see us pass it, or at least get it up for a vote. The House is waiting for us to act. I think that should be our first priority.

Meanwhile, I think it's a fair question whether we need to tinker with this jurisdictional issue until we get that done. I look forward to today's testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Secretary Glauber.

STATEMENT OF ROBERT R. GLAUBER, UNDER SECRETARY OF THE TREASURY FOR FINANCE, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. GLAUBER. Thank you very much, Mr. Chairman.

I have a somewhat longer prepared statement. With your permission, I would like to read excerpts and have the entire prepared statement placed in the record.

The CHAIRMAN. Without objection, so ordered. Please go ahead.

Mr. GLAUBER. Thank you.

WE BELIEVE THE TIME HAS COME TO REFORM THE DISJOINTED REGULATION OF THE MARKETS GOVERNING STOCKS, STOCK OPTIONS, AND STOCK-INDEX FUTURES

Mr. Chairman, Senator Lugar, and members of the committee:

Thank you for this opportunity to discuss the administration's views on regulatory fragmentation and related issues in the securities and futures markets. We believe the time has come to reform the disjointed regulation of the markets governing stocks, stock options, and stock-index futures.

We also believe that if steps are not taken to correct the problem now, we are more likely to see minor events trigger major market disruptions like the breaks in October of 1987 and October of 1989—and the appropriate regulatory tools will not be in place to help contain the risk to this country's financial system. Finally, a failure to act will impede innovation; drive new financial instruments to overseas markets; and thwart enforcement of intermarket abuses.

As Secretary Brady has said many times, any reform must be based upon the fact that the markets for stocks, stock options, and stock-index futures are really "one market." The financial community already recognizes this fact, as do regulators in other countries. The question is whether our regulatory structure needs change in order to recognize this fact as well—whether one market requires one regulator, and whether this will result in progress on

key intermarket issues that will reduce the likelihood and risk of major market disruptions.

We believe the answer to all these questions is yes. As a result, the administration will submit proposed legislation this week. Before outlining this proposal, however, let me explain why the administration has come to this position.

THE ONSET OF MAJOR MARKET DISRUPTIONS

As this committee knows, stock-index futures began trading on futures exchanges less than 10 years ago. These instruments have proved to be one of our financial system's most innovative new developments, and we believe their use has helped keep our cost of capital lower than it otherwise would be.

Nevertheless, the interaction of these new instruments with stocks and stock options has been an important contributor to major market disruptions—periods when the markets disconnect with prices spiraling down. These major market disruptions are not episodes of markets adjusting to fundamental changes in value or responding to major news events. They are periods when the markets break down, as history has shown us.

In the 52 years between 1930 and 1982, the year stock-index futures began trading, the Dow Jones Industrial Average declined by more than 6 percent on only three occasions: when the Germans took the Netherlands in May of 1940 (6.8 percent); when they encircled the Allied Forces at Dunkirk just days later in the same month (6.8 percent); and when President Eisenhower suffered a heart attack in September of 1955 (6.5 percent). By contrast, as the futures markets have grown, such massive 1-day selloffs have occurred four times in the last 3 years:

October 19, 1987—22.6 percent.
October 26, 1987—8.0 percent.
January 8, 1988—6.9 percent.
October 13, 1989—6.9 percent.

Not one of these days corresponded with any major news events like the ones before 1982. But they all shared the characteristic of enormous selling pressure from the stock-index futures markets.

We believe the problem is not an increase in average price volatility, because we have consistently recognized that there is no compelling evidence that average stock market volatility has increased over the past 25 years.

Instead, the problem is infrequent episodes of violent disruptions when the markets cease to function correctly. During these episodes, pricing relationships between stocks and futures break down; markets in particular instruments experience difficulties in staying open; serious supply-demand imbalances develop; and very large market moves occur in the absence of underlying fundamental information.

It is the increased potential for and consequences of these major market disruptions that lead us to urge prompt regulatory reform.

SYSTEMIC RISK AND EROSION OF INVESTOR CONFIDENCE

The most disturbing consequence is the risk these major market disruptions pose to the entire financial system, especially through

the clearance and settlement process. For example, after the October 1987 break, the clearance and settlement system fell over 6 hours behind its normal payment times, with futures clearinghouses owing over $1.5 billion to investment houses. Had these funds been missing for any significantly longer time, it would have unleashed a chain reaction of events where other payments to other creditors would not have been made. The Presidential Task Force concluded that the prospect of clearinghouse failures reduced the willingness of lenders to finance market participants, leading to "a crisis of confidence [that] raised the spectre of a full-scale financial system breakdown."

Obviously, we must take appropriate steps to reduce this very real risk of a systemic breakdown.

Moreover, we need to address another consequence of these major market disruptions—their contribution to the erosion of investor confidence and capital formation.

To bring investors back into our markets to stay, we must renew their confidence that market mechanisms are operating efficiently and that they are still a safe place to invest.

REGULATORY FRAGMENTATION

We believe the fundamental impediment to reducing the likelihood of major market disruptions—and its consequences to the system and to investors—is regulatory fragmentation. One regulator for the "one market" would have much more flexibility to coordinate the key intermarket mechanisms that disconnect to create or exacerbate major market disruptions. These include the following:

CLEARANCE AND SETTLEMENT

First, clearance and settlement: I have already described the systemic risks posed by potential breakdowns in our fragmented clearance and settlement systems. While legislation is pending in both the Senate and the House to help address these systems, there is little doubt that a single regulator could help accelerate the coordination process.

UNHARMONIZED MARGINS

The second market mechanism is unharmonized margins. While there is Federal oversight of margins in the stock and stock options markets, there is virtually none in the stock-index futures markets. The result is a tremendous disparity among margin levels in the three markets, with futures margins often dipping to dangerously low levels. The fact is that futures traders can control so great an amount of stock with so little of their own money that relatively small amounts of capital can concentrate enormous selling pressure on the stock market—great enough to cause a major market disruption that could punch a hole in the fabric of the financial system.

However, since these margins are set by the futures industry, with no day-to-day regulatory oversight, there is no way to harmonize margins between futures and stocks to protect the public. This exposure to systemic risk requires Federal oversight of margin-

setting for stock-index futures, and the oversight should come from one regulator that can ensure harmonized margins among linked markets.

UNCOORDINATED CIRCUIT BREAKERS

Finally, we must deal with uncoordinated circuit breakers. Some progress has been made to coordinate circuit breakers in stock and stock-index futures markets, and discussions are continuing within the President's Working Group on Financial Markets. Nevertheless, more can be done, and fundamental disagreements continue to exist between markets and their regulators over the appropriate kinds of circuit breakers.

In short, fragmented regulation has impeded progress on the coordination of these fundamental intermarket mechanisms. We believe one regulator with appropriate authority could accelerate progress substantially toward the harmonized regulation we need to address the problem of major market disruptions.

Let me now say a word about the fact that regulatory fragmentation is now creating a serious impediment to innovation. This was not always true—in the past, fragmented regulation sometimes promoted innovation.

But regulatory competition also begets jurisdictional squabbles, which can strangle innovation.

The result has been protracted litigation over what constitutes a "future"; an inability to trade in the U.S. market most suited to the product; and the shifting of business to more hospitable overseas markets. This is precisely what happened to Index Participation Certificates, which now trade in Toronto rather than in the United States.

My point is this: With the globalization of financial markets, other countries have provided us all the regulatory competition we need. We can no longer afford jurisdictional conflicts that stifle innovation at home and drive important business overseas.

ENFORCEMENT AND GLOBALIZATION

Finally, let me mention two other problems created by regulatory fragmentation. The first is ineffective intermarket enforcement.

INEFFECTIVE INTERMARKET ENFORCEMENT

With two different regulators, it becomes extremely difficult to prevent manipulation and fraud in transactions between the stock and futures markets. The situation is similar to State troopers who are forced to stop at the State line when chasing lawbreakers. In particular, it is extremely difficult to detect intermarket "frontrunning," where a trader trades ahead of his client in one market knowing that the client's trade will drive a linked market in a particular direction.

We believe that integrated regulation would enhance surveillance, facilitate intermarket rulemaking, and promote accountability.

GLOBALIZATION

The final problem involves the clear trend toward globalization of financial markets. I have already discussed how this overseas competition requires the United States take the steps necessary to foster domestic innovation. But it also requires viewing interrelated domestic markets in a global context and speaking with one voice to our foreign counterparts.

Indeed, every other country with major trading in stocks and stock-index futures has a single regulator to make sure its financial system as a whole is protected. The SEC regulates stocks and stock options while the CFTC regulates stock-index futures. That situation should be corrected.

RECOMMENDED SOLUTIONS

Let me turn now to our recommended solutions. This does not need to be complicated because we do not need more regulation. But we do need more unified regulation as the umbrella under which specific intermarket issues can be much more easily resolved. The result will be more streamlined and efficient regulation.

Unifying regulation could involve the more substantial action of merging the SEC and the CFTC, as some Members of Congress have suggested. Another approach would shift the regulation of all financial futures from the CFTC to the SEC. However, both of these proposals involve major regulatory changes that are more than is necessary to address the problems we believe require immediate correction.

Instead, the administration supports a less sweeping approach that would only unify regulation of the "one market" of stocks, stock options, and stock-index futures under the SEC, the agency with the greatest expertise in the combination of these products. The proposal the administration will submit will do the following:

First, shift regulatory authority for stock-index futures to the SEC, but in a manner that minimizes the disruption to the current operation of the markets in these instruments.

Second, provide the SEC with oversight authority over the futures exchanges' ability to set margins, which would be similar to its current oversight authority over margin-setting by the options exchanges—there would be no pre-set minimum margins established by statute.

Third, modify the "exclusivity clause" of the Commodity Exchange Act in order to end pointless litigation and remove barriers to innovation that are driving new products to foreign markets.

Fourth, enhance enforcement authority, especially on an intermarket basis.

Fifth, provide an appropriate transition.

And sixth, a mandate report within 18 months on any additional modifications that are necessary for efficient regulation of the "one market" of stocks, stock options, and stock-index futures.

The administration believes that this is the most appropriate approach for addressing regulatory fragmentation with the least disturbance to and best protection for the futures markets. Moreover, it would have no effect on the agricultural community, since stock-

index futures have no relation to agricultural products or agricultural futures.

The proposal would also minimize the effect on the CFTC, because stock-index futures represent less than 10 percent of the futures volume under CFTC jurisdiction. Indeed, the CFTC will be able to concentrate its considerable expertise on the more traditional agricultural and financial futures products that have long been the core of its jurisdiction.

CONCLUSION

In conclusion, the benefits of unified regulation are substantial. While we embrace this approach, I want to emphasize our belief that today's problems do not come from the regulators themselves. Both the CFTC and the SEC are doing a good job under difficult circumstances—administering a scheme of regulation that simply is not designed for the unified marketplace they are expected to regulate. We believe the answer is a coherent regulatory structure that can deal effectively with unified markets. Resolving regulatory fragmentation will reduce systemic risk and promote investor confidence, which are keys to our long-term competitiveness.

Moreover, led by Chairman Gramm, I believe the CFTC will continue its outstanding job of ensuring the integrity and safety and soundness of the markets it regulates. I urge the Senate to speedily confirm Chairman Gramm for another term, so that the CFTC will have the leadership necessary to address these matters successfully.

Mr. Chairman, that concludes my testimony.

The CHAIRMAN. Thank you.

Mr. GLAUBER. I will be happy to answer questions when my time comes.

[The prepared statement, letter, and answers to questions of Mr. Glauber follow:]

Statement of
The Honorable Robert R. Glauber
Under Secretary of the Treasury for Finance
Before the
U.S. Senate Committee on
Agriculture, Nutrition, and Forestry

May 8, 1990

Chairman Leahy, Senator Lugar, and Members of the Committee:

Thank you for this opportunity to discuss the Administration's views on regulatory fragmentation and related issues in the securities and futures markets. We believe the time has come to reform the disjointed regulation of the markets governing stocks, stock options, and stock index futures.

We also believe that if steps are not taken to correct the problem now, we are more likely to see minor events trigger major market disruptions like the breaks in October of 1987 and October of 1989 -- and the appropriate regulatory tools will not be in place to help contain the risk to this country's financial system. Finally, a failure to act will impede innovation; drive new financial instruments to overseas markets; and thwart enforcement of intermarket abuses.

As Secretary Brady has said many times, any reform must be based upon the fact that the markets for stocks, stock options, and stock index futures are really "one market." The financial community already recognizes this fact, as do regulators in other countries. The question is whether our regulatory structure

needs change in order to recognize this fact as well -- whether one market requires one regulator, and whether this will result in progress on key intermarket issues that will reduce the likelihood and risk of major market disruptions.

We believe the answer to all these questions is yes. As a result, the Administration will submit proposed legislation this week. Before outlining this proposal, however, let me explain why the Administration has come to this position.

The Onset of Major Market Disruptions

As this Committee knows, stock index futures began trading on futures exchanges less than ten years ago. These instruments have proved to be one of our financial system's most innovative new developments, and we believe their use has helped keep our cost of capital lower than it otherwise would be. They have also permitted institutional traders to engage in more effective asset allocation techniques and have provided a more flexible mechanism to enter and exit the stock market.

Nevertheless, the interaction of these new instruments with stocks and stock options has been an important contributor to major market disruptions -- periods when the markets disconnect with prices spiraling down. These major market disruptions are not episodes of markets adjusting to fundamental changes in value

3

or responding to major news events. They are periods when the markets break down, as history has shown us.

In the 52 years between 1930 and 1982 (the year stock index futures began trading) the Dow Jones Industrial Average declined by more than 6 percent on only three occasions: when the Germans took the Netherlands in May of 1940 (6.8 percent); when they encircled the Allied forces at Dunkirk just days later in the same month (6.8 percent); and when President Eisenhower suffered a heart attack in September of 1955 (6.5 percent). As the futures markets have grown, such massive one-day selloffs have occurred four times in the last three years:

October 19, 1987 -- 22.6 percent
October 26, 1987 -- 8.0 percent
January 8, 1988 -- 6.9 percent
October 13, 1989 -- 6.9 percent

Not one of these days corresponded with any major news events like the ones before 1982. But they all shared the characteristic of enormous selling pressure from the stock index futures markets.

Again, these were not merely days of "excessive price fluctuations" or "increased volatility." Beginning with the Report of the Presidential Task Force on Market Mechanisms,

chaired by Secretary Brady, we have consistently recognized that there is no compelling evidence that average stock market volatility has increased over the past 25 years. But that is completely beside the point.

The problem is not an increase in average price volatility, but the infrequent episodes of violent disruptions when the markets cease to function correctly. During these episodes, pricing relationships between stocks and futures break down; markets in particular instruments experience difficulties in staying open; serious supply-demand imbalances develop; and very large market moves occur in the absence of underlying fundamental information.

It is the increased potential for and consequences of these major market disruptions that lead us to urge prompt regulatory reform.

Systemic Risk and Erosion of Investor Confidence

The most disturbing consequence is the risk these major market disruptions pose to the entire financial system, especially through the clearance and settlement process. For example, after the October 1987 break, the clearance and settlement system fell over 6 hours behind its normal payment times, with futures clearinghouses owing over $1.5 billion to

investment houses. Had these funds been missing for any significantly longer time, it would have unleashed a chain reaction of events where other payments to other creditors would not have been made. The Presidential Task Force concluded that the prospect of clearinghouse failures reduced the willingness of lenders to finance market participants, leading to "a crisis of confidence [that] raised the spectre of a full-scale financial system breakdown."

Obviously, we must take appropriate steps to reduce this very real risk of systemic breakdown.

Moreover, we need to address another consequence of these major market disruptions -- their contribution to the erosion of investor confidence and capital formation:

- Initial Public Offerings (IPOs) have plummeted since the 1987 market break. After peaking at $18 billion in 1986, IPOs raised only about $6 billion a year in 1988 and 1989.

- Equity offerings as a percentage of new funds raised domestically has fallen off dramatically. In the early 1980s, equity accounted for about 30-50 percent of all public new issues, but the share dwindled to only 10 percent in 1989.

- The percentage of stock outstanding held by individuals has declined from 84 percent in 1965 to 55 percent in 1989.

- Trading volume in options, futures, and stocks is off substantially from levels that prevailed before the October 1987 market break.

To bring investors back into our markets to stay, we must renew their confidence that market mechanisms are operating efficiently and that they are still a safe place to invest.

Regulatory Fragmentation

The fundamental impediment to reducing the likelihood of major market disruptions -- and its consequences to the system and to investors -- is regulatory fragmentation. One regulator for the "one market" would have much more flexibility to coordinate the key intermarket mechanisms that disconnect to create or exacerbate major market disruptions. These include the following.

Clearance and Settlement. I have already described the systemic risks posed by potential breakdowns in the clearance and settlement systems. This continues to be what Secretary Brady has described as the weakest link in the financial system. The problem is the fragmentation of clearing systems among the

stock, stock options, and stock index futures markets. While legislation is pending in both the Senate and House to help address these systems, there is little doubt that a single regulator could help accelerate the coordination process.

Unharmonized Margins. While there is federal oversight of margins in the stock and stock options markets, there is virtually none in the stock index futures markets. The result is a tremendous disparity among margin levels in the three markets, with futures margins often dipping to dangerously low levels. The fact is that futures traders can control so great an amount of stock with so little of their own money that relatively small amounts of capital can concentrate enormous selling pressure on the stock market -- great enough to cause a major market disruption that could punch a hole in the fabric of the financial system.

For example, just prior to the October 13, 1989 break, a professional trader in the futures market with $50,000 in cash could control almost $2,000,000 in stock, which is nearly 10 times more than the $200,000 that a professional trader in the stock market can control with the same amount of cash. Many observers were astounded that, while stock index futures margins were increased temporarily in the wake of the October 1987 break, they were actually lower in October of 1989 than they were in October of 1987.

The result is that during market downdrafts, when the system is most in need of liquidity, futures exchanges are forced to restrict liquidity through margin calls because margins have been set so low. This is precisely the opposite of what should occur: during emergencies it is critical to pump liquidity into the system.

Thus, low futures margins create a direct prudential risk not merely to the futures markets, but to the financial system as a whole. However, since these margins are set by the futures industry, with no day-to-day regulatory oversight, there is no way to harmonize margins between futures and stocks to protect the public. This exposure to systemic risk requires federal oversight of margin-setting for stock index futures, and the oversight should come from one regulator that can ensure harmonized margins among linked markets.

Evasion of Short Selling Restrictions. For over 50 years the securities laws have restricted bear raiders like the 1920s' Jessie Livermore from selling short in declining markets. The purpose of these restrictions is to prevent "gunning" the market, which drives down the market and confuses the small investor. However, a concerted selling effort in the futures market can completely undermine the short selling restriction -- and in fact, because of low futures margins, can accelerate the

stock market downdraft. Again, it is critical to harmonize these intermarket rules to prevent manipulators from using one market to evade restrictions in another market.

Uncoordinated Circuit Breakers. Some progress has been made to coordinate circuit breakers in stock and stock index futures markets, and discussions are continuing within the President's Working Group on Financial Markets. Nevertheless, more can be done, and fundamental disagreements continue to exist between markets and their regulators over the appropriate kinds of circuit breakers.

In short, fragmented regulation has impeded progress on the coordination of these fundamental intermarket mechanisms. We believe one regulator with appropriate authority could accelerate progress substantially towards the harmonized regulation we need to address the problem of major market disruptions.

Barriers to Innovation

Apart from major market disruptions, regulatory fragmentation is now creating a serious impediment to innovation. This was not always true -- in the past, fragmented regulation sometimes promoted innovation. Competition between Chicago and New York markets spurred new product development,

while the practices of different regulators often promoted diversity, experimentation, and creativity.

But regulatory competition also begets jurisdictional squabbles, which can strangle innovation. New products are not merely stifled; they quickly move to overseas markets.

This is particularly true with respect to the so-called "exclusivity" clause of the Commodity Exchange Act (CEA). As a result of regulatory disputes, the courts currently interpret this provision to require that any financial instrument with any degree of "futurity" must be traded on a futures exchange. But certain of the new "hybrid" products are simply not amenable to trading in this manner. The result has been protracted litigation over what constitutes a "future"; an inability to trade in the U.S. markets most suited to the product; and the shifting of business to more hospitable overseas markets. This is precisely what happened to Index Participation Certificates, which now trade in Toronto rather than the United States.

My point is this: with the globalization of financial markets, other countries have provided us all the regulatory competition we need. We can no longer afford jurisdictional conflicts that stifle innovation at home and drive important business overseas.

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Enforcement and Globalization

The other problems created by regulatory fragmentation involve intermarket enforcement and globalization.

Ineffective Intermarket Enforcement. With two different regulators, it becomes extremely difficult to prevent manipulation and fraud in transactions between the stock and futures markets. The situation is similar to state troopers who are forced to stop at the state line when chasing lawbreakers. In particular, it is extremely difficult to detect intermarket "frontrunning," where a trader trades ahead of his client in one market knowing that the client's trade will drive a linked market in a particular direction. In fact, at this time there is not even a universally accepted definition of illegal frontrunning in the cross-market context.

The plain fact is that with our current system it is simply too easy for intermarket abuses to slip through the cracks because of the dispersion of regulatory responsibility. Integrated regulation would enhance surveillance, facilitate intermarket rulemaking, and promote accountability.

Globalization. The clear trend toward globalization of financial markets has now been recognized. I have already discussed how this overseas competition requires the United

States take the steps necessary to foster domestic innovation. But it also requires viewing interrelated domestic markets in a global context and speaking with one voice to our foreign counterparts.

Secretary Brady, testifying before the Senate Banking Committee last October, described the growing interdependence of the world's financial markets and supported the idea of identifying particular issues where an international and intermarket approach would be useful. Integrating "one market" regulation in the U.S. would obviously facilitate the process. In addition, integrated regulation would enable us to deal more effectively with foreign governments by speaking in a unified and consistent way.

Indeed, every other country with major trading in stocks and stock index futures has a single regulator to make sure its financial system as a whole is protected. Japan, the United Kingdom, and France, which together with the United States account for 90 percent of global futures trading, recognize the "one market" reality -- each country assures that regulation of stocks, options, and futures is coordinated by a single regulator. Yet here in the United States, by reason of historical accident, the Securities and Exchange Commission (SEC) regulates stocks and stock options, while the Commodity Futures Trading Commission (CFTC) regulates stock index futures.

Recommended Solutions

Before outlining the Administration's proposal, let me emphasize the importance of avoiding an approach that will stifle innovation. This is the effort to ban or drastically curtail program trading. We believe that this blunt approach of government intervention is simply the wrong way to address these problems. Rather than trying to restrict particular trading strategies, it is much more productive to focus on inconsistent intermarket regulation.

Again, to do this we must recognize that what we now have is a single market with uncoordinated and even conflicting regulation. That may have created benefits in the past when markets were less connected and overseas competition was minimal. But now it creates substantial problems, as I have just described.

The solution is not complicated. We do not need more regulation. But we do need more unified regulation as the umbrella under which specific intermarket issues can be much more easily resolved. The result will be more streamlined and efficient regulation.

Unifying regulation could involve the more substantial action of merging the SEC and the CFTC, as some members of Congress have suggested. Another approach would shift the regulation of all financial futures from the CFTC to the SEC. However, both of these proposals involve major regulatory changes that are more than is necessary to address the problems we believe require immediate correction.

Instead, the Administration supports a less sweeping approach that would only unify regulation of the "one market" of stocks, stock options, and stock index futures under the SEC, the agency with the greatest expertise in the combination of these products. The proposal the Administration will submit will:

-- Shift regulatory authority for stock index futures to the SEC, but in a manner that minimizes the disruption to the current operation of the markets in these instruments;

-- Provide the SEC with oversight authority over the futures exchanges' ability to set margins, which would be similar to its current oversight authority over margin-setting by the options exchanges (there would be no pre-set minimum margins established by statute);

-- Modify the "exclusivity clause" of the Commodity Exchange Act in order to end pointless litigation and remove barriers to innovation that are driving new products to foreign markets;

-- Enhance enforcement authority, especially on an intermarket basis;

-- Provide for appropriate transition; and

-- Mandate reports within eighteen months on any additional modifications that are necessary for the efficient regulation of the "one market" of stocks, stock options, and stock index futures.

The Administration believes that this is the most appropriate approach for addressing regulatory fragmentation with the least disturbance to and best protection for the futures markets. Moreover, it would have no effect on the agricultural community, since stock index futures have no relation to agricultural products or agricultural futures.

The proposal would also minimize the effect on the CFTC, because stock index futures represent less than 10 percent of the futures volume under CFTC jurisdiction. Indeed, the CFTC will be able to concentrate its considerable expertise on the more

traditional agricultural and financial futures products that have long been the core of its jurisdiction.

Conclusion

In conclusion, the benefits of unified regulation are substantial. While we embrace this approach, I want to emphasize our belief that today's problems do not come from the regulators themselves. Both the CFTC and the SEC are doing a good job under difficult circumstances -- administering a scheme of regulation that simply is not designed for the unified marketplace they are expected to regulate. We believe the answer is a coherent regulatory structure that can deal effectively with unified markets. Resolving regulatory fragmentation will reduce systemic risk and promote investor confidence, which are keys to our long-term competitiveness.

Moreover, led by Chairman Gramm, I believe the CFTC will continue its outstanding job of ensuring the integrity and safety and soundness of the markets it regulates. I urge the Senate to speedily confirm Chairman Gramm for another term, so that the CFTC will have the leadership necessary to address these matters successfully.

Mr. Chairman, that concludes my testimony. I would be pleased to answer any questions the Committee may have.

* * * * *

DEPARTMENT OF THE TREASURY
WASHINGTON

UNDER SECRETARY

June 18, 1990

The Honorable Patrick Leahy
Chairman
Committee on Agriculture,
Nutrition, and Forestry
United States Senate
Washington, DC 20510-6000

Dear Mr. Chairman:

Enclosed are my answers to the questions you submitted following the May 8 hearing on SEC-CFTC jurisdiction. We are hopeful that Congress will enact the Administration's proposal, the "Capital Markets Competition, Stability, and Fairness Act of 1990," this year. The May 8 hearing was very helpful in clarifying the issues relating to SEC-CFTC jurisdiction.

Sincerely,

Robert R. Glauber

Enclosure

TRANSFER OF STOCK INDEX FUTURES

Question 1:

Would you propose to ban or substantially restrict program trading strategies like index arbitrage or portfolio insurance?

Answer:

Although we share concerns that have been expressed about problems associated with excessive market volatility, we continue to believe that the blunt approach of government intervention to stop program trading is an inappropriate way to address these problems. Rather than attempting to restrict particular program trading strategies, which would stifle innovation, it is much more productive to focus on inconsistent intermarket regulation of margins, clearing and settlement, circuit breakers, etc.

Question 2:

What risk disclosure would you propose be required for retail salesmen to provide on opening customer accounts to trade stock-index futures: a futures-style disclosure document as required under CFTC rules, or a securities-style prospectus?

Answer:

Our proposal would transfer to the SEC the authority to regulate transactions in stock index futures and options on stock index futures under the basic structure of the Commodity Exchange Act. We chose the Commodity Exchange Act rather than the Securities Exchange Act in order to minimize the disruption to stock index futures markets and market participants. Thus, the Commodity Exchange Act and the rules, regulations and interpretations thereunder would be the starting point. Thereafter it would be up to the SEC to decide whether the existing disclosure requirements adopted by the CFTC are sufficient for stock index futures customers. Chairman Breeden has testified that stock index futures customers should have the same protections as securities customers, but we do not know whether he would view the longer disclosure under the securities laws to be preferable to the summary disclosure required under the commodity laws. Because the bill does not address this issue specifically, we have not taken a position on it and would not want to second-guess the SEC's regulatory judgment.

Question 3:

Would you propose to require each exchange trading stock-index futures to create a separate clearinghouse for its stock-index markets separate from its other commodities, and for these clearinghouses to be unified? Would you propose to require each such exchange to register as a national securities exchange?

Answer:

The bill does not specifically address treatment of clearinghouses. It would be for the SEC to decide in the exercise of its authority under the Commodity Exchange Act whether current regulation of clearinghouses should be altered. Futures exchanges that continue to trade only stock index futures and other futures contracts would not become subject to registration as securities exchanges.

Question 4:

What registration requirement would you propose to apply to floor traders [locals] in the stock-index futures pits, and who would implement this requirement? As a general matter, would you propose that futures registrations under the National Futures Association be recognized by the SEC?

Answer:

We understand that S. 1729 contains a new registration requirement for floor traders. The Administration bill would transfer to the SEC the powers and responsibilities currently exercised by the CFTC under the Commodity Exchange Act concerning, among other things, any person purchasing or selling stock index futures contracts. Therefore, if S. 1729 is enacted in conjunction with the Administration bill, then the SEC would have the same authority to require registration of floor traders trading stock index futures as the CFTC would have with respect to floor traders trading other futures contracts.

The Administration bill would provide continuity for the contract markets and regulated persons whose activities in stock index futures and options thereon brought them under the jurisdiction of the SEC. The persons currently registered would be deemed registered with the SEC on the effective date. All orders, rules and regulations, and interpretations under the Commodity Exchange Act, rules of the contract markets, and rules of the National Futures Association relating to stock index futures and regulated

persons would remain in effect until modified, terminated, set aside or superceded in accordance with applicable law.

Question 5:

Would you propose to apply the anti-fraud provisions of the Commodity Exchange Act to stock-index futures trading, and would you propose that case decisions by the CFTC and federal courts be considered as precedent in interpreting this provision?

Answer:

The anti-fraud provisions of the Commodity Exchange Act would continue to apply to trading in stock index futures. In addition, the bill would amend the definition of "security" under the Securities Exchange Act to treat stock index futures and options thereon as securities for purposes of that Act's general antifraud prohibitions and related enforcement authority. Accordingly, the SEC and private litigants would have the ability to enforce and bring private damage actions under SEC rule 10b-5, including actions relating to insider trading, fraudulent sales practices, and other causes of action where the violative conduct occurred in connection with the purchase or sale of a stock index future or option thereon. Under section 10(b) the SEC also has the ability to engage in additional rulemaking concerning manipulative or deceptive devices or contrivances relating to transactions in stock index futures or options thereon. These amendments would supplement the authority of the SEC to administer and enforce the existing anti-fraud provisions of the Commodity Exchange Act with respect to stock index futures. Case decisions by the SEC, CFTC, and federal courts could be considered as precedent in interpreting these provisions.

Question 6:

Would you propose to require commodity pools to register as "investment advisors" or "investment companies" under relevant securities laws?

Answer:

The bill would not amend the Investment Company Act or the Investment Advisers Act, so existing law under those Acts would continue to apply.

Question 7:

Would you propose to require computerized, tamper-proof audit trails for stock-index futures pits, as we have done

in S. 1729? If so, would you propose to extend this requirement to stock option markets to assure a "level playing field?"

Answer:

We generally support this provision of S. 1729 and note that if S. 1729 were enacted in conjunction with our proposed bill, the SEC would have the same authority with respect to audit trails for stock index futures as the CFTC would have with respect to other futures contracts. Our goal in transferring jurisdiction over stock index futures to the SEC is to produce coordinated regulation and to enhance intermarket surveillance. Whether the audit trail requirement of S. 1729 should be extended to stock option markets is a regulatory matter for the SEC to determine under the securities laws in light of these important goals. We would note that the stock options markets have not had significant audit trail problems and the Committee bill would not apply the audit trail provision of S. 1729 to stock option markets.

Question 8:

Would you propose to allow state securities administrators to play a role in regulating the retail marketing of stock-index futures to public customers? or to sue firms defrauding customers?

Answer:

The bill would not affect the preemption of state law under the exclusivity clause of the Commodity Exchange Act with respect to stock index futures as currently traded, so state securities administrators would continue to be limited to bringing actions under the provisions of the Commodity Exchange Act and rules thereunder.

Question 9:

Would you propose that the SEC conduct economic purpose tests of new stock-index products to assure that they are usable for commercial "hedging" or "price-basing" and that purely speculative instruments are not allowed?

Answer:

The bill would not revise the existing economic purpose test under the Commodity Exchange Act, so the SEC would have to find that the test is satisfied before approving new stock index futures products.

Question 10:

What structure would you propose for the SEC to coordinate with the Commodity Futures Trading Commission on inter-market/inter-agency issues or enforcement matters involving exchanges or firms which trade simultaneously both SEC-regulated stock-index futures and CFTC-regulated futures in other commodities?

Answer:

The SEC and CFTC already coordinate surveillance and enforcement to some extent through the Intermarket Surveillance Group and have coordinated rulemaking that affects registrants under both the securities and commodities laws. Although the bill does not specifically require consultation on enforcement matters, it provides that, in promulgating rules in the exercise of powers and responsibilities granted by the bill, the SEC is specifically required to consider the sufficiency of any existing rules as well as the views of the CFTC. This is similar to the provision in the Government Securities Act that requires Treasury to consider the views of the SEC in promulgating rules relating to government securities. This consultation requirement has worked well in the regulation of government securities, and the purpose of the similar provision here is to promote the greatest degree of cooperation between the two Commissions, particularly during transition, with minimum disruption to the regulation and operation of the stock index futures markets.

Question 11:

Would you propose to direct the SEC enforcement staff to bring cases directly against floor traders in the stock-index futures pit who violate trading rules rather than leaving this function solely to the exchanges [as I understand is the SEC's current practice with regard to securities exchanges]? If so, would the SEC enforcement division require significant increases in staff levels?

Answer:

There would be no limitation on the SEC's authority to bring cases directly against floor traders in the stock index futures pits. Whether exchange enforcement of trading rules is sufficient without direct action by the SEC is a matter for the SEC to decide in the exercise of its authority as regulator.

Question 12:

Would you propose to require that customers or traders maintain separate accounts for trading futures in stock indices apart from futures in other commodities? Should funds in customer accounts be subject to segregation requirements as under current commodity laws?

Answer:

As a starting point, the existing segregation requirements of the CFTC regarding customer funds would continue to apply. Thereafter this would be a regulatory issue for the SEC to determine with respect to stock index futures. Whether customers-or traders would have to maintain separate accounts for stock index futures apart from other futures would be a matter for the SEC and CFTC to determine under their respective authorities.

Question 13:

Would you propose to require that public members sit on exchange disciplinary committees when they hear cases against floor traders, particularly exchange "insiders"? If so, would you consider extending this rule to securities markets?

Answer:

We generally support this provision of S. 1729. Whether a similar requirement should apply to securities markets should be determined in the first instance by the securities self-regulatory organizations and the SEC.

Question 14:

As of today, the Chicago Mercantile Exchange's margin requirements for its futures contracts on the Standard and Poor 500 index are as follows:

-- initial margin for speculative positions: $20,000 per contract, or about 12 percent.

-- maintenance margin and initial margin for commercial hedge positions: $7,500, or about 5 percent.

Do you believe that these margins in effect today are adequate given current market conditions and current levels of securities margin? If not, how high would you raise them?

Answer:

It would not be appropriate for me to try to pick a specific level for how high stock index futures margins should be, but they do need to be harmonized with margins on stocks. The only way to ensure that margins are harmonized on an ongoing basis is to provide for federal regulation of margins on stocks and stock derivative products. Our bill would do so by granting the SEC oversight authority over the futures exchanges' ability to set margin on stock index futures, which would be similar to its existing authority over margin-setting by the options exchanges (which has in effect been delegated by the Federal Reserve). As with margins on options, the bill would not set pre-established margin limits by statute.

CFTC "EXCLUSIVITY"

Question 1:

CFTC "exclusivity" now means that only one Federal agency, the CFTC, can today regulate trading on, say, the crude oil futures contract at the New York Mercantile Exchange. Would you propose to allow several federal agencies, say the Departments of Energy and Interior and the SEC, to simultaneously issue rules affecting this market alongside the CFTC? Or would you allow just one agency at a time?

Answer:

The bill would not affect the exclusive jurisdiction of the CFTC over futures contracts on tangible products like crude oil. The bill would make the SEC the exclusive regulator of transactions in stock index futures.

Question 2:

The "index participation," to which you refer, was approved to trade on a regulated national securities exchange? Would you propose to allow futures contracts to be approved if they are not going to trade on any regulated exchange: neither a futures exchange nor a securities exchange?

Answer:

Under the bill the only time the Commodity Exchange Act would apply to transactions in securities hybrid futures contracts (like index participations) would be when they are

futures contracts approved for trading on a designated contract market. Otherwise, securities hybrids would be subject to regulation under the federal securities laws, whether or not they are traded on an exchange.

Question 3:

Would you propose to allow a futures contract on, say, crude oil to trade under the sole or principal regulation of a state government? Or of a non-financial federal agency like the Energy Department [or timber futures under the U.S. Forest Service]?

Answer:

The bill does would not change existing law concerning the CFTC's exclusive jurisdiction over futures contracts on tangible commodities (other than securities indexed to tangible commodities, as explained in my answer to Question 1).

Question 4:

Would you propose to allow futures exchanges under CFTC regulation to trade non-futures instruments such as securities options, or to trade futures contracts on individual stocks?

Answer:

The bill does not change existing law in this area.

Question 5:

Would you propose that the anti-fraud and anti-manipulation provisions of the Commodity Exchange Act apply to futures contracts which are exempted from CFTC "exclusive" jurisdiction?

Answer:

The anti-fraud and anti-manipulation provisions of the Commodity Exchange Act would only apply to swaps, securities hybrids like index participations, and "Treasury amendment" products if they were futures contracts approved for trading on a designated contract market. The latter group of products are those that are included in the existing exemption from the Commodity Exchange Act known as the "Treasury amendment." Other schemes of regulation, such as the securities or banking laws, could apply to hybrid products that are explicitly excluded from the Commodity Exchange Act. The CFTC would have authority to exempt from

all of the provisions of the Act except the antifraud provisions those hybrid products that are not explicitly excluded.

Question 6:

You say on p. 10 of your testimony that under current law, "any financial instrument with any degree of 'futurity' must be traded on a futures exchange." Yet the Commodity Exchange Act, section 2(a)(1)(A), provides the following:

"Nothing in this Act shall be deemed to govern or in any way be applicable to transactions in foreign currency, security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, or mortgages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade. The term 'future delivery' as used herein, shall not include any sale of any cash commodity for deferred shipment or delivery."

These two provisions, called the "Treasury amendment" and the "forward contract exemption," are designed to exempt the large bulk of commercial transactions with "elements of futurity" from coverage under the Commodity Exchange Act.

Please explain your blanket statement about "futurity" in light of these provisions from current law?

Answer:

We support the Treasury amendment and the forward contract exemption, but clarification of these exemptions is needed. Recent cases involving cash index participation contracts (Chicago Mercantile Exchange v. SEC) and 15-day Brent oil contracts (Transnor (Bermuda) Limited v. BP North America Petroleum et al.) raise serious concerns about the potential for exposure by participants in over-the-counter trading of products having an element of futurity.

Moreover, the CFTC in the past has tried to interpret the Treasury Amendment more narrowly than the words would permit, i.e., by reading an institutional market limitation into the scope of the exclusion.

The bill would address these concerns by creating a new, broader exception from the exclusivity clause for transactions involving securities, clarifying other existing exceptions found in the "Treasury Amendment," and clarifying that swap agreements are not subject to the Commodity Exchange Act provided they are undertaken by the parties to the agreement in conjunction with their business (including

financial intermediation) or risk hedging activities. The only instance when the Commodity Exchange Act would be applicable to the instruments listed above is when they are futures contracts and are conducted on a designated contract market. In addition, the CFTC would be given specific authority to exempt transactions involving financial instruments that arguably have some degree of futurity (but do not involve delivery of a tangible commodity) from regulation under the Commodity Exchange Act, other than the anti-fraud provision, if the exemption would be consistent with the public interest.

Question 7.A.:

Why does it not concern you, as a representative of the Treasury Department, that stripping the CFTC of jurisdiction over stock-index futures could, and according to Chairman Gramm WOULD weaken its ability to police futures markets in Treasury bonds and foreign currencies? As you know, the Chicago treasury bond pit, the Japanese yen pit, and the Swiss franc pit all were principal targets of last year's FBI "sting" operation, netting together indictments of more than 25 traders.

Answer:

We believe that our bill is the most appropriate approach for addressing regulatory fragmentation with the least disturbance to and best protection for the futures markets. The proposal would minimize the effect on the CFTC, because stock index futures represent less than 10 percent of the futures volume under CFTC jurisdiction. Indeed, the CFTC will be able to concentrate its considerable expertise on the more traditional agricultural and financial products that have long been the core of its jurisdiction.

Question 7.B.:

To the extent that your "exclusivity" proposal would allow these financial futures contracts to fall under the regulation of an agency other than the SEC or the CFTC with no background in regulating organized trading in such instruments, why does this not concern you?

Answer:

Our bill would not change existing law with respect to the ability of agencies other than the CFTC and SEC to regulate financial futures contracts traded on a designated contract market.

The CHAIRMAN. Chairman Breeden, we are delighted to have you here. Please go ahead, sir.

STATEMENT OF RICHARD C. BREEDEN, CHAIRMAN, U.S. SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. BREEDEN. Thank you, Chairman Leahy, Senator Lugar, and members of the committee, for inviting me to testify on the subject of intermarket regulation.

The critical issue before us is how we can best preserve the health and well-being of our Nation's securities and futures markets.

The CHAIRMAN. Are you following the testimony that you gave us?

Mr. BREEDEN. No, sir. With permission, I will submit that for the record. I have a shorter oral statement that I will deliver.

The CHAIRMAN. It would be helpful if the witnesses might shorten their oral statements somewhat. They have very lengthy prepared statements, which are very helpful to us. But we have many questions we would like to ask in the time available.

Senator BOSCHWITZ. Does the witness have a copy?

Mr. BREEDEN. I would be happy to provide you with one.

Senator BOSCHWITZ. Do you have any copies?

Mr. BREEDEN. If I give you the one I am about to read, I will be left without one.

The CHAIRMAN. Do you have a copy of the full prepared statement?

Senator BOSCHWITZ. Yes.

The CHAIRMAN. Go ahead, Mr. Breeden.

THE CRITICAL ISSUE BEFORE US IS HOW WE CAN BEST PRESERVE THE HEALTH AND WELL-BEING OF OUR NATION'S SECURITIES AND FUTURES MARKETS

Mr. BREEDEN. The critical issue before us is how we can best preserve the health and well-being of our Nation's securities and futures markets. The answers that we reach will have profound implications for these markets as well as for the strength and competitiveness of the U.S. economy as a whole.

REFORM OF THE REGULATORY STRUCTURE IS URGENTLY NEEDED

As you know, and as Secretary Glauber has just described, Treasury Secretary Nicholas Brady strongly believes that the current system of fragmented regulation of stocks, options on stocks, and stock-index futures undermines the stability and competitiveness of the U.S. capital markets, and that reform of the regulatory structure is urgently needed.

I share his very strong concerns regarding this matter. The Commission intends to support prompt enactment of the President's proposed legislation that Under Secretary Glauber has just described.

FRAGMENTED REGULATORY STRUCTURE CAUSES NUMEROUS PROBLEMS

The Commission believes that the present regulatory system is seriously flawed and that the results are unnecessary risk for the

markets and unjustifiable barriers to competition. The present fragmented regulatory structure causes numerous problems, many of which are described in the Commission's testimony and that of the Treasury Department. Therefore, I will touch only briefly on those issues.

JURISDICTION AND THE EXCLUSIVITY PROVISIONS IN THE COMMODITY EXCHANGE ACT

First, the division of jurisdiction between the SEC and the CFTC has interfered with the ability of U.S. financial markets to compete with their global counterparts. Because of the exclusivity provision in the Commodity Exchange Act, useful products cannot trade on the U.S. markets and U.S. corporations lose valuable flexibility in seeking financing at the lowest possible cost. In essence, the exclusivity clause amounts to a legislative grant of monopoly trading privileges. All monopolies produce inefficiency, and this one is no exception.

Sadly, the expenditure of millions of dollars in legal fees and years of delay in bringing new products to market is necessary only in the United States. Other major markets do not exalt the proper regulatory classification of products over their economic usefulness. British Petroleum, Olivetti, Hitachi, Hyundai, West Pak, Volvo, Hong Kong Telecom, and other companies around the world can issue hybrid securities in markets outside the United States without having to pay the costs of litigating over the exclusivity of commodities regulation.

The exclusivity clause is, in our view, a self-inflicted wound on the cost of capital in the United States, an anchor that only American companies have to drag through the water. Over time, this law will do enormous damage to both the vitality of our securities markets and the strength of the broader U.S. economy.

The fragmentation of regulatory authority has also resulted in a system in which margins on stock and options are subject to Federal oversight but margins on stock-index futures are not. As a result, the futures exchanges have at times set stock-index futures margins at extremely low levels. During normal market conditions, this may not create a significant problem. But, when market conditions become extreme, these low margin requirements can create enormous risks. When the market is in trouble, the stock-index futures markets can resemble a flash flood following a desert thunderstorm due to these margin practices. This situation creates unnecessary risks to the stability of the overall U.S. financial system.

The risks of low margin extend far beyond the futures markets into the stock markets and the American economy generally. Virtually every U.S. citizen would be impacted if there were a significant interruption of the national clearance and settlement system, which, in the aggregate, including all of our markets, processes trillions of dollars in transactions every day.

To date, we have had two examples of a serious weakness in the existing system. The potential impact of decisions to keep stock-index futures margins at extremely low levels is sufficiently great that leaving the role of protecting the public interest, the prudential interest, solely to the private futures exchanges without any

Federal oversight is not justifiable. In my view, the issue is not whether our current system is alright during a bright, sunny day. Rather, the question is: Is our current ship strong enough to remain afloat in a storm?

The fragmented regulatory structure also makes it much more difficult to detect and deter intermarket fraud. Under the present regime, neither the SEC nor the CFTC has full power to address intermarket frontrunning and manipulation, because neither agency has a complete picture of what is going on in the other market. We can and do cooperate in investigations, and both agencies work hard to control fraud under the current system. But the structure itself makes it more difficult for either agency to know where and when to investigate.

THE THREE-POINT PROGRAM THAT THE ADMINISTRATION HAS PROPOSED AND THAT WE SUPPORT WOULD HELP US SOLVE OR SIGNIFICANTLY REDUCE THESE PROBLEMS

The three-point program that the administration has proposed and that we support would help us solve or significantly reduce these problems. It would benefit both the securities and the futures markets, and it would certainly benefit the American public.

A NUMBER OF MYTHS HAVE BEEN PUT FORWARD DURING THE COURSE OF THIS DEBATE

However, a number of myths have been put forward during the course of this debate which I would like to briefly address. First, it has been alleged that the SEC is anticompetitive and against innovation. Nothing could be further from the truth. Under the SEC's oversight, a vast array of innovative and inventive new securities have been developed over the years.

SOME OF THE SECURITIES PRODUCTS THAT HAVE BEEN INTRODUCED DURING THE PAST DECADE

Some of the securities products that have been introduced during the past decade include the following—and my full testimony has a longer list—but the list includes: mortgage-backed securities and asset-backed securities of every type, index-linked securities, adjustable rate preferred stocks, reverse principal exchange rate-linked securities, variable duration notes, money market preferred shares, master limited partnership units, and perpetual debt instruments. Literally hundreds of these products raising hundreds of billions of dollars have been issued and traded as securities.

Indeed, probably the most innovative and economically productive financial development in the markets over the last decade has been the entire process of securitization of financial assets of every type.

The CHAIRMAN. Are junk bonds in that same list?

Mr. BREEDEN. High-yield securities of various types would certainly be among the types of securities that could come to the market under our oversight, yes, sir.

The CHAIRMAN. Just thought I would check. Go ahead.

Mr. BREEDEN. In my March 2 testimony before the Senate Banking Committee, I told Senators Gramm and D'Amato that I would

agree to substitute the term "high-yield securities" for "junk bonds." And so if you will allow me to at least honor my commitment——

The CHAIRMAN. As long as we both understand what we're talking about, and I rather suspect we do——

Mr. BREEDEN. This process has occurred under the jurisdiction granted the SEC by the securities laws. Securities products trade publicly and privately on exchanges and over-the-counter, in virtually any way the market finds useful. In contrast, futures contracts can trade in only one Government-mandated way, on a designated contract market. As a result, the Chicago Mercantile Exchange today actively trades about 30 to 40 different types of futures contracts, while there are literally thousands of different securities products available to investors.

ANOTHER CANARD

Another canard that has surfaced during the jurisdictional debate is the notion that the administration's proposal would seriously damage the futures markets. Market participants, in my judgment, will gravitate to markets that provide the strongest and most stable trading environment. The proposed changes should make both the securities and futures markets stronger, and they should make stock-index futures more attractive to many investors who are currently prohibited from participating or are unwilling to participate in the futures markets.

Similarly, there is little reason to fear that establishing a system of Federal oversight with respect to stock-index futures margins would drive trading in those instruments abroad. I would point out that speculative margins on stock-index futures were raised to 16 percent after the October 1987 market break. During the time while margins were maintained at higher levels, before being slashed to roughly their 1987 levels, not a single foreign futures market even began trading a future on a U.S. stock index.

PROPONENTS OF THE CURRENT SYSTEM HAVE ALSO ARGUED THAT TRANSFER OF STOCK-INDEX FUTURES TO THE SEC WOULD WEAKEN THE CFTC SUBSTANTIALLY

Proponents of the current system have also argued that transfer of stock-index futures to the SEC would weaken the CFTC substantially and interfere with its ability to regulate the futures markets for agricultural commodities and other types of financial instruments. Frankly, the Commission does not understand how that would happen. Stock-index futures make up only about 5 percent of all futures trading. Indeed, last year alone 250 million futures contracts not involving stock-index futures were traded.

Thus, moving jurisdiction over stock-index futures to the SEC should not have any impact on most of the CFTC's current oversight responsibilities. In fact, such a shift might even be positive, since it would allow the CFTC to concentrate its resources and expertise on the markets for agricultural and physical commodities that it was established to regulate, as well as the interest rate and foreign currency futures that are the overwhelmingly dominant products of the futures exchanges today.

SUGGESTED THAT THE DEBATE IS NOTHING MORE THAN A TURF WAR

Finally, it has been suggested that the debate over the administration's proposal is nothing more than a turf war. That also is simply not the case. The SEC supports the proposals of the administration because we believe that both the securities and the futures markets would be better off if the stability and competitiveness of our system were improved. In our view, the important question is not whether the proposals at issue would benefit or harm the SEC or the CFTC staff, but how we can best serve the interests of the American public in having a strong and vigorously competitive market.

IMPERATIVE FOR CONGRESS TO ACT SWIFTLY TO REFORM THE REGULATORY SYSTEM FOR STOCKS, STOCK OPTIONS, AND STOCK-INDEX FUTURES IN ACCORDANCE WITH THE PLAN DESCRIBED ABOVE

The fragmentation of regulatory responsibility over the equities markets has had serious consequences for those markets. As a result, the Commission believes that it is imperative for Congress to act swiftly to reform the regulatory system for stocks, stock options, and stock-index futures in accordance with the plan described above.

If we cannot agree to take effective action against these problems, opportunities to reduce the costs of capital for issuers of securities will be lost, to the detriment of prospects for a strong economy. The financial industry, in which the United States is strongly competitive globally, will face serious long-term damage. Significant systemic risks that are completely avoidable will continue, with the potential for serious cost and damage to our economy over the long term.

Thank you very much.

[The prepared statement, letter, and responses of Mr. Breeden follow:]

TESTIMONY OF

RICHARD C. BREEDEN, CHAIRMAN
U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING INTERMARKET REGULATION

BEFORE THE COMMITTEE ON AGRICULTURE, NUTRITION & FORESTRY
UNITED STATES SENATE

MAY 8, 1990

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

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Chairman Leahy and Members of the Committee:

It is my pleasure to appear before you today to express the views of the Securities and Exchange Commission concerning the allocation of regulatory responsibility for our nation's financial markets.

I. A PROPOSAL TO STRENGTHEN FINANCIAL OVERSIGHT

Since 1934, Congress has entrusted the Commission with the protection of the integrity, stability, and competitiveness of our nation's securities markets. For nearly 60 years, the SEC has promoted competition while working vigorously to prevent fraud and manipulation and to protect the stability of the overall market system. Our mandate is as important today as it was when first enacted.

The fulfillment of that mandate has been made more difficult, however, by our fragmented regulatory structure. In order to address the problems that we have already experienced, and to prevent the emergence of new problems, the Commission supports enactment of legislation seeking to accomplish three objectives:

1. The exclusivity clause of the Commodity Exchange Act ("CEA") should be repealed insofar as it would apply to financial instruments that are regulated by another federal or state primary regulatory agency.

2. Regulation of margins on stock index futures by self-regulatory organizations should be subject to oversight and approval by the SEC, or alternatively the Federal Reserve Board.

3. Jurisdiction over stock index futures should be transferred to the SEC, thereby creating a unified system for the regulation of stocks and derivatives on those stocks, while preserving their regulation as futures under the CEA.

The three-point program that the Commission has recommended would address many of the critical problems that are currently

afflicting the U.S. equity markets. For that reason, the Commission believes that adoption of the legislation that the Administration has announced it will propose would serve the public interest and benefit both futures markets and securities markets in the U.S. Participation in both sets of markets would increase as a result of enhanced market stability and public confidence, leading to a long-term increase in the markets' liquidity.

II. SERIOUS PROBLEMS ARE CREATED BY THE CURRENT MARKET STRUCTURE

In our previous testimony on this issue, the Commission explained in detail the problems that have been caused by the fragmented regulatory structure. These problems are real, they are hurting our markets, and they will only get worse unless Congress takes the necessary steps to reform the regulatory system. Let me summarize our concerns:

A. The division of jurisdiction between the SEC and the CFTC has interfered with the ability of U.S. markets to compete with other international markets.

Today, U.S. markets must compete in a globalized environment that did not exist 16 years ago when the Commodity Futures Trading Commission ("CFTC") was first created, or even eight years ago when stock index futures were first traded. Since the last time Congress examined the jurisdictional issue, the exclusivity provision of the Commodity Exchange Act has subjected U.S. financial firms seeking to introduce new products to extensive and wholly wasteful litigation. By adding years of delay and millions in legal fees to the introduction of new products, the exclusivity clause has prevented a number of potentially valuable products from trading in the U.S. markets. Index Participations ("IPs") have been banished from the U.S. market, and other hybrid instruments have been deterred or driven offshore.

This result is not in the best interests of the exchanges and corporate issuers that sought to issue these products, or of the investors who are denied the opportunity to purchase these products. Indeed, application of this broad and ill-defined provision of the CEA damages the best interests of the U.S. economy, which is robbed of the benefits of competition and innovation. While exclusivity may be a useful concept with respect to regulation of futures contracts by other levels of government, it is extremely destructive when applied to banking, securities or insurance products already under comprehensive federal or state primary regulation.

B. The fragmentation of regulatory authority has adversely affected market stability.

Divided regulatory responsibility also has resulted in unharmonized systems of margin regulation that threaten the

stability of our nation's markets. Because margins on stock index futures are not subject to federal regulation, these margins have been set by the futures exchanges without regard to the best interests of the markets generally. At critical times, these margins have been set close to zero.

Low margin levels on stock index futures encourage speculative trading in such futures, which creates the appearance of deep liquidity during normal market conditions. When the markets are stressed and prices begin to fall rapidly, however, the illusion disappears. Liquidity in the stock index futures markets evaporates suddenly, causing price declines that are already occurring to accelerate. Price declines in the index futures, which can resemble a flash flood following a desert thunderstorm, are transmitted almost instantaneously through index arbitrage to the stock market.

The CFTC and others assert that there is not any academic proof that low margins contribute to price volatility. It is a fact, however, that the frequency of dramatic price declines with systemic implications has increased ominously during recent years. For example, in the last four years the Dow Jones Industrial Average has declined by more than 4% on 10 separate occasions. Prior to that time, a decline of this magnitude had not occurred even once since at least 1970.

More importantly, the argument over volatility misses the real problem entirely. The problem is that margins on the S&P 500 futures contract are typically too low to protect with certainty the safety of the clearance and settlement system, especially in the event of a sharp fall in the market. The problem isn't volatility on a bright sunny day. The problem is whether our current ship is strong enough to remain afloat in a storm.

Both in 1987 and again in 1989, we entered a market emergency with margins as low as 2-3% on the Chicago Mercantile Exchange ("CME"). It is a fact that, on both occasions, margins had to be raised sharply. Indeed, hedge margins were raised by $1,000 per contract after the close on both October 13 and 16, 1989, and speculative margins were raised by $3,000 per contract after the close on October 13, 1989. It is also a fact that futures market participants had to pay more than $500 million to satisfy increases in margin levels in stock index futures on the CME during these two days. In other words, over half a billion dollars of liquidity was withdrawn from the system during this crucial period.

In a recent speech, E. Gerald Corrigan, President of the Federal Reserve Bank of New York, referred to the actions the CME was forced to take last October to raise margins in the midst of the market's problems:

> [A] good case can be made that margins should be high enough in the first instance that they don't need to be raised in emergency situations. Indeed, to take it one step further, the mere fact that margins must be raised in an emergency suggests that they may have failed to perform their functions.
>
> Partly for this reason, ... I believe that margins in many financial-type futures instruments are typically -- if not systematically -- too low. In the case of the S&P 500 contract, for example, it seems to me that a significantly higher margin -- perhaps as high as 15 percent or so -- is always called for. I also have serious doubts as to the wisdom of leaving the day-to-day establishment and administration of minimum margins to the exchanges.[1]

What Treasury Secretary Brady, President Corrigan and others have observed is that the need sharply to raise low margins during a market disturbance could be the catalyst that turns a temporary drop in the stock market into a free-fall in all equities products that could inflict significant damage on the overall U.S. economy. Significantly, other industrialized nations with developed futures markets do not allow individual market participants to exercise final responsibility for protecting the overall financial system. Indeed, failure to address this problem, after witnessing two near-misses, would be difficult to justify.

C. <u>The divided regulatory structure frustrates attempts to detect and prosecute intermarket fraud.</u>

Fragmented regulatory authority also interferes with the ability of the SEC and the CFTC to prevent intermarket frontrunning and manipulation. Regulatory coordination is not adequate to solve this problem. Under the current system neither the SEC nor the CFTC necessarily knows where or when to look because each agency sees only one-half of each intermarket transaction. The result is an inability to detect and deter attempts to rig swings in the market. This conduct can harm participants in both markets, and it will undercut public confidence in market integrity.

Furthermore, because of the split in regulatory jurisdiction, the securities and futures exchanges have not been able to reach prompt agreements with respect to information sharing and other intermarket matters, and the agreements that have been reached are more limited than is the case for stock and options exchanges.

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[1]Speech by E. Gerald Corrigan, President, Federal Reserve Bank of New York, at the 62nd Annual Mid-Winter Meeting of the New York State Bankers Association (January 25, 1990).

D. **Fragmentation of regulatory responsibility hinders efforts to reduce systemic risk in the clearance and settlement system.**

Because of the dual regulatory system, efforts to reduce systemic risk in the clearance and settlement system have not been fully successful. For example, efforts have been made to develop cross-margining programs in order to reduce unnecessary demands for liquidity during times of market stress. Despite these efforts, only two pilot cross-margining programs have been implemented to date as a result of jurisdictional obstacles to expansion of those programs. The result is less market liquidity, higher costs and greater systemic risks for the public.

E. **The separation of regulatory authority impedes efforts to obtain cooperative agreements with foreign regulatory authorities.**

At present, no single U.S. agency can negotiate comprehensive agreements with foreign regulatory agencies, which universally have authority with respect to both equity and equity derivative markets. Instead, regulatory cooperation agreements must either be negotiated in separate stages, or negotiations must include both agencies. This structure makes obtaining good international agreements more expensive, more time-consuming, and less effective in terms of the overall U.S. national interest than it would be if a single agency had authority to negotiate these agreements.

Enactment of the legislation supported by the Commission would solve, or substantially mitigate, each of these serious problems. Implementation of the jurisdiction transfer would be accomplished by transferring authority to administer the CEA to the SEC with respect to equity derivatives. By leaving equity index futures under their existing statutory framework, there should not be any serious operating difficulty for these products. The result would be more competition, lower overhead, better detection of fraud and more effective international negotiations for the benefit of both the securities and the futures markets. In addition, by freeing more of the CFTC's time and managerial talent to concentrate on products relating to agricultural and physical commodities, those markets should also be strengthened.

III. THE PROPOSED LEGISLATION WOULD NOT RESULT IN ADVERSE EFFECTS

A number of arguments have been raised against creation of unified regulation for the equity market. These arguments either are incorrect or simply miss the point.

A. **The SEC is a pro-competitive agency with a demonstrated record of promoting innovation and competition.**

Critics have suggested that, had the SEC possessed regulatory jurisdiction over the futures markets, innovative products such as stock index futures would never have developed. The CFTC, on the other hand, is asserted repeatedly to have encouraged the development of new products. The facts do not support these assertions. Indeed, far more new and innovative products have come to market under SEC oversight than through the futures markets.

Some observers focus only on the number of so-called new products introduced by particular markets. The genius of the federal securities laws, however, is the flexibility that they provide to corporate issuers to offer new products to investors directly, without relying on the market to act as the issuer. Unlike the futures markets, where prior approval of a board of trade and the CFTC is required before a new product can be offered, there is not any requirement for SEC approval of new types of securities being offered by corporate issuers to investors other than compliance with disclosure and antifraud standards of various types. The SEC doesn't "authorize" many new products, because issuers aren't required to ask our approval.

In the last ten years, corporate issuers have been able to register and sell hundreds of new types of securities under the jurisdiction of the Commission. The total volume of such innovative securities has easily been hundreds of billions, if not trillions, of dollars. These securities have included:

- pass-through mortgage-backed securities;
- collateralized mortgage obligations;
- stripped mortgage participation certificates;
- certificates for automobile receivables;
- interests in recreational vehicle loans;
- interests in credit cards receivables;
- interests in home equity loans;
- interests in time-sharing loans;
- interests in commercial mortgages;
- interests in refinanced military loans;
- silver-indexed, oil-indexed, copper-indexed, and natural gas-indexed notes;

- volume-indexed subordinated debentures;
- Standard & Poors 500 Index subordinated notes;
- U.S. dollar bond index-linked securities;
- cumulative exchangeable adjustable rate preferred stock
- reverse principal exchange rate-linked securities and currency exchange warrants;
- real estate appreciation notes;
- liquid yield option notes;
- variable duration notes;
- Nikkei 225 put warrants;
- FT-SE 100 put warrants;
- foreign currency denominated notes;
- money market preferred shares;
- annuity notes;
- master limited partnership units;
- payment in kind debentures;
- resettable rate notes; and
- perpetual debt instruments.

These products were deliberately crafted to sell and trade as securities, subject to the SEC's pro-competitive regulatory regime. Offerings of some of these products, as well as certain banking products, were delayed as a result of uncertainty over CFTC assertions of jurisdiction based on that agency's interpretations as to when a hybrid debt product falls under the CEA.

The SEC has also encouraged innovation in the offering of new derivative products by the options exchanges. Since approving the trading of standardized options in the 1970s, the SEC has approved new product proposals for the trading of options on:

- stock indexes;
- Treasury bonds, bills, and notes;

- Government National Mortgage Association instruments;
- debt indexes; and
- foreign currencies.

In contrast to the federal securities laws, the structure of the CEA is decidedly anti-competitive. Under the exclusivity clause of the CEA, a product that is deemed to be a future cannot trade except on a designated contract market. Indeed, in the recent IPs decision Judge Easterbrook noted that the structure of the CEA "gives the futures markets the opportunity to block competition from [any] innovative financial product" that can be labelled a future.[2] The federal securities laws do not contain any comparable restriction, and indeed securities products trade through a variety of off-exchange mechanisms.

B. Despite a reputation for innovation, futures exchanges actually rely on monopoly trading privileges.

Today, the exclusivity clause of the CEA poses a severe threat to the international competitiveness of the U.S. markets. In today's global market, if a product useful to investors cannot trade in the United States, it will surely trade elsewhere. Thus, whatever benefits the exclusivity provision may once have offered, it now has the effect of squelching competition and driving securities business to more competitive and more rationally regulated foreign markets.

Corporate issuers are also hurt by the current system. Japanese, German, French and U.K. companies that wish to lower their cost of capital by issuing a hybrid security do not have to wait years, or pay enormous legal fees to resolve metaphysical issues of futurity. In their markets, stocks and derivatives on stocks are under the same system, so it doesn't make a difference whether a product is 100% a security or only 90%. Similarly, Nomura Securities in Tokyo or Warburgs in London do not have to comply with two entirely different agencies and compliance systems in order to trade in stocks, options and stock index futures. The enormous costs of two separate layers of duplicative regulation are borne only by firms in the U.S. market, to our great disadvantage.

When we consider the costs that are imposed by the anticompetitive effects of the exclusivity clause on the entire financial system and on our nation's international competitiveness, it seems clear that the exclusivity clause is contrary to our national interest. The Commission does not believe that it is

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[2] Chicago Mercantile Exchange et al. v. SEC et al., 883 F.2d 537, 548-9 (7th Cir.), reh'g denied 883 F.2d 550 (1989), petition for cert. pending.

sound public policy for the futures regulatory scheme to swallow that of the rest of the financial markets. The risk-shifting function of the futures markets, albeit economically valuable, cannot be allowed to destroy the efficiency of the capital-raising function of the securities markets, which provides the funds necessary for future U.S. economic growth.

c. Securities exchanges under SEC oversight have advanced automated systems.

Securities markets subject to the SEC's oversight and regulation also have been leaders in the introduction of trading and clearance and settlement innovations. For example, the securities industry has a long history of providing trade-by-trade information to market participants as part of the consolidated tape, an innovation that the futures markets have yet to match. Similarly, for years securities market audit trails have captured the time of execution of each trade. This is not true in the futures markets where, even today, a time is simply imputed for most stock index futures transactions. This extremely imprecise system makes reconstruction of trading sequences in a fraud investigation quite difficult.

Starting as early as 1969, the securities exchanges and the National Association of Securities Dealers developed a variety of automated information dissemination, order routing, trade execution, and comparison and settlement systems that have greatly enhanced the efficiency and competitiveness of U.S. securities markets. Indeed, the first fully automated market for futures or securities was the National Securities Trading System of the Cincinnati Stock Exchange, which begin operating, after SEC approval, in 1978, a full decade before Globex was conceived.

Likewise, broker-dealers have incorporated a high degree of automated processing into their trading and trade settlement operations, again with the encouragement and support of the SEC. In addition, a variety of innovative proprietary trading systems have been introduced into securities markets. This has been fostered by the SEC's flexible and pro-competitive application of the securities laws, notwithstanding fierce opposition from the futures markets. In another recent lawsuit brought by the futures exchanges, this time to prevent a new proprietary trading system from being allowed to compete, the court observed that proprietary trading systems "faced opposition from the futures markets, which did not savor competition."[3]

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[3] Board of Trade of the City of Chicago v. SEC, 883 F.2d 525, 528 (7th Cir. 1989).

D. **Unified jurisdiction over stocks, stock options and stock index futures would strengthen efforts to prevent fraud.**

The SEC's recommendations also would improve public confidence in all of the equities markets by reducing opportunities for fraud. A simple example will suffice. The New York Stock Exchange ("NYSE") and the CME did not reach agreement concerning frontrunning prohibitions until seven years after the S&P 500 futures contract was introduced. In contrast, all options exchanges have long prohibited frontrunning pursuant to circulars, approved by the SEC as rules, issued a decade ago. These frontrunning prohibitions are fully applicable to frontrunning in index options.

Furthermore, the Intermarket Surveillance Group (the "ISG") was organized at the SEC's behest in order to ensure that an adequate surveillance structure would exist to police frontrunning. The ISG allows options and stock exchanges access to each other's audit trail and clearing information. In contrast, the CME's agreement with the NYSE provides only limited access to CME audit trail data.[4] Moreover, there is still no frontrunning agreement between the NYSE and the Chicago Board of Trade. A single regulator with authority over both the stock and stock index futures markets would have had the ability to put comprehensive prohibitions against frontrunning in place much sooner. In addition, a single regulator would unquestionably have required a frontrunning agreement between the NYSE and the Chicago Board of Trade.

E. **This is not a "turf" contest, or an issue of Chicago versus New York.**

The issues before Congress concern serious problems confronting the U.S. financial system, not turf. Despite attempts to mischaracterize our views, the Commission's support for the proposed new legislation described herein is based on our view that this legislation would improve the stability and competitiveness of U.S. capital markets. Many other government officials and market participants favor similar proposals.[5]

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[4]For example, under the terms of the agreement, the CME will supply audit trail data to the NYSE only with respect to those accounts that trade above certain threshold levels. In addition, any information exchanged under the agreement, if not otherwise publicly available, may be used only for surveillance with respect to intermarket trading abuses recognized as such by the rules of both exchanges.

[5]Statement of the Honorable Robert R. Glauber, Under Secretary of the Treasury for Finance, Before the Subcommittee on Securities, U.S. Senate Committee on Banking, Housing, and Urban Affairs

Even more far-fetched is the portrayal of this issue as a battle between the interests of New York and Chicago. In fact, the SEC already regulates two large national securities exchanges located in Chicago, without any serious allegations of bias toward New York. Presumably the CFTC also does not treat the several futures exchanges located in New York unfairly. Diverting attention from the real issues by characterizing a genuine substantive disagreement as a "turf war" or as a battle between Wall Street and La Salle Street may be good rhetoric, but it is simply not true. This is a fundamental question concerning the structure of our market that deserves careful consideration strictly limited to the merits.

In reality, Americans in every state have an interest in lowering the cost of capital for U.S. enterprises to improve their international competitiveness. Similarly, traders, investors and other market participants in every state would benefit from stronger efforts to prevent fraud.

F. Transfer of stock index futures jurisdiction to the SEC would not weaken the ability of the CFTC to regulate futures on other commodities.

Stock index futures currently comprise approximately 5% of all futures trading, and only one of the twenty largest futures contracts (measured by contract volume) is based on a stock index.[6]

(Mar. 29, 1990); Testimony of the Honorable Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, Before the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs, Transcript at 92 (Mar. 29, 1990); Statement of the Honorable Dennis E. Eckart on the Introduction of the Markets and Trading Reorganization and Reform Act (Apr. 4, 1990); Statement of the Honorable Dan Glickman on the Introduction of the Markets and Trading Reorganization and Reform Act (Apr. 4, 1990); 134 Cong. Rec. E2285 (July 7, 1988) (statement of Rep. Edward J. Markey upon the introduction of the the Securities Market Reform Act of 1988); Statement of Edward I. O'Brien, President, Securities Industry Association, Before the Subcommittee on Energy and Commerce, U.S. House of Representatives (May 3, 1990); Investor's Daily, Apr. 16, 1990, at 27 (statement of Richard Fisher, President, Morgan Stanley Group); Letter from Philip J. Purcell, Chairman and Chief Executive Officer, Dean Witter Financial Services Group, Inc., to the Honorable Edward J. Markey (June 6, 1988).

[6]During 1989, stock index futures contracts represented only 4.97% of all futures contracts traded, compared with 5.84% during 1988. Futures Industry Association, Volume of Futures Trading 1960 Through 1989 (1990). By contrast, other financial futures account

Thus, the limited transfer of stock index futures to the SEC should not adversely affect the CFTC's ability to regulate all other futures markets, given that more than 250 million futures contracts not involving equity indexes were traded in 1989.

Moreover, there is not any reason to believe that the transfer of stock index futures jurisdiction to the SEC will lead to the piecemeal dismantling of the CFTC's jurisdiction. The relationship between the stock index futures market and the underlying cash market for stocks is significantly different due to the existence of a significant cash market (unlike the market for physical commodities), and due to the relatively large size of the derivative market compared with the cash market (unlike the market for other financial futures). Therefore, transfer of stock index futures jurisdiction represents the core of the current problem.

G. Higher futures margins will not drive stock index futures trading offshore.

Some have argued that raising margins on stock index futures contracts will drive trading in those instruments to other countries. The fallacy of this argument is demonstrated by the fact that, even though speculative margins were raised to 16% after October 1987, no foreign futures market even began trading a future on a U.S. stock index, much less attracted volume away from a U.S. futures exchange. Indeed, the second largest stock index futures market -- Japan -- currently requires speculative margin on the two Japanese stock index futures that can be as high as 19.9% and 26.7%. Therefore, assertions of dire consequences from higher margins are utterly unfounded.

IV. OTHER POSSIBLE SOLUTIONS TO THE PROBLEMS CAUSED BY FRAGMENTED REGULATORY JURISDICTION

The three-part program supported by the Commission would cure the most pressing problems in our nation's equity markets.[7] It

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for a much greater percentage of trading volume. For example, in 1989, interest rate futures accounted for 46.25% of all futures contracts traded, while foreign currency futures accounted for 10.08%. Futures Industry Association, Volume of Futures Trading 1960 Through 1989 (1990).

[7]Commissioner Fleischman concurs in the recommendation concerning modification of the exclusivity provisions of the CEA. As to reform of margin regulation, Commissioner Fleischman remains convinced of the soundness of the legislative proposal submitted by the Commission on July 6, 1988 and therefore disagrees with the recommendation in this testimony. As to jurisdictional change, on the basis of his understanding of principles of financial regulation articulated in the Report of the Task Group on

also would not have any adverse impact on the present regulatory structure or the futures markets for agricultural, energy, and non-financial commodities.

Several alternative proposals are, in the SEC's view, also feasible. For example, the Commission would support the combination of oversight of all securities, options, and futures activities within a single agency. Commissioner Schapiro strongly believes that of the alternatives under consideration, merger is the best alternative for both the futures and securities markets. Such a merger would reduce taxpayer costs by eliminating duplication between these agencies. It would also reduce the compliance costs of market professionals by facilitating the development of unified registration and regulatory requirements. At the same time, investors would be likely to benefit in terms of increased convenience and decreased costs, as well as facilitating the ability to receive timely information regarding investment alternatives between stocks, options and futures. In addition, merger of the agencies would bring both the securities and the futures markets under a single regulator, thereby providing a more efficient mechanism for resolution of intermarket jurisdictional disputes in the future.

A merger of the two agencies would not need to disrupt the basic statutory structure under which the securities and futures markets operate. Assuming appropriate statutory changes to address the margin and exclusivity issues discussed above, a single regulator could regulate all futures products as futures pursuant to the CEA, and all securities products as securities pursuant to the federal securities laws.

Nevertheless, despite its potential benefits, a full merger is not necessary in order to fix the most glaring problems in the current regulatory system. The Commission believes that transferring regulation of stock index futures to the SEC, in conjunction with legislation to harmonize margin systems and to modify significantly the exclusivity clause, would be sufficient to address these problems. Therefore, at this time the Commission advocates this more limited three-point program.

V. CONCLUSION

The fragmentation of regulatory responsibility over the equities markets has had serious consequences for those markets. As a result, the Commission believes that it is imperative that Congress act swiftly to reform the regulatory system for stocks, stock options, and stock index futures in accordance with the three-point plan described above. If we cannot agree to take

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Regulation of Financial Services (July 1984), Commissioner Fleischman disagrees with the recommendation in this testimony.

effective action against these problems, opportunities to reduce the cost of capital for issuers of securities will be lost, to the detriment of prospects for a strong economy. The securities industry, in which the United States is strongly competitive globally, will face serious long-term damage. Significant systemic risks that are completely avoidable will continue, with an unknown probability of extremely serious cost and damage to the economy and the public.

On the other hand, if we consolidate the regulation of at least equity products now, we will have taken a major step to rationalize an overly-cumbersome system. In this way we can demonstrate that the United States is willing to modernize our overall system to promote both safety and competitiveness, and determined to maintain U.S. leadership in capital markets.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON D.C. 20549

THE CHAIRMAN

July 10, 1990

The Honorable Patrick Leahy
Chairman
Committee on Agriculture,
Nutrition and Forestry
United States Senate
Washington, D.C. 20510-6000

Dear Chairman Leahy:

Enclosed are my responses to the questions raised in your letters of May 11 and May 19, 1990 relating to my May 8 testimony before the Committee. Please do not hesitate to contact me if I can be of further assistance.

Sincerely,

Richard C. Breeden
Chairman

Enclosures

ENCLOSURE

July 10, 1990

Responses of the Securities and Exchange Commission
to Questions of Senator Leahy

I. Transfer of Stock-Index Futures

Question A:

What is the view of each of the four SEC Commissioners toward the principal proposal of the Administration that the CFTC be stripped of its jurisdiction over stock index futures and that this responsibility be transferred to the SEC?

Answer:

In general, Commissioner Schapiro, Commissioner Lochner, Commissioner Fleischman and I each share the view of the Administration that the status quo requires modification to promote the long run safety and efficiency of the U.S. capital markets.

In particular, each of the four Commissioners shares the opinions of Treasury Secretary Nicholas Brady, Federal Reserve Chairman Alan Greenspan and Federal Reserve Bank of New York President E. Gerald Corrigan that the current system of establishing margins without any public oversight should be changed. Different Commissioners have different ideas concerning which federal agency would be most desirable for providing margin oversight, but all agree that margin levels should not be immune from federal oversight.

Commissioners Schapiro, Lochner and I all believe that the fact that the Chairman of the Federal Reserve testified that he was "shaken" by the risk created by the margin decisions of the Chicago

exchanges last October provides vivid commentary on why the current system is inadequate to protect the safety of the more than $3 1/2 trillion in savings of the American public invested in the equity securities market. Indeed, the fact that margins on stock index futures set by the Chicago Mercantile Exchange ("CME") have been as low as 2.2% at the time of both the 1987 and 1989 crashes was instrumental in causing Chairman Greenspan to change his previous view that margin decisions could safely be left to self-regulatory organizations ("SROs"). The demonstrated inability of the futures exchanges to limit leverage to less than 97.8% proves that reform is necessary to control excessive levels of speculation through creating a system for the review of SRO margin decisions by a federal agency.

Similarly, all four Commissioners believe that the so-called "exclusivity clause" of the Commodity Exchange Act ("CEA") represents a public policy decision that requires change in light of developments since 1974. To the extent that the clause contributes to monopoly trading privileges, all Commissioners believe the clause perpetuates economically inefficient markets. Indeed, the Seventh Circuit Court of Appeals observed in a recent decision that the exclusivity clause "gives the futures markets the opportunity to block competition from an innovative financial product." (883 F.2d 548-9, 7th Circuit) All Commissioners believe that the clause, as interpreted by the courts, unnecessarily raises the cost of capital to U.S. business by impeding productive innovation, creates needless litigation, and drives financial

products offshore that could otherwise be offered in U.S. markets. The repeated use of litigation under the exclusivity clause by the CME and the Chicago Board of Trade ("CBOT") is an example of unnecessary cost that damages America's capital markets. In this area the unanimous view of the Commissioners is again similar to Federal Reserve Board Chairman Greenspan and Treasury Secretary Brady, each of whom has supported repeal or modification of the exclusivity clause.

With respect to jurisdiction over stock index futures, three of the four Commissioners believe that the U.S. system should reflect that of every other major capital market, where stocks, options and stock index futures are all ultimately subject to oversight by a single governmental agency. In Japan, with a stock index futures market nearly the size of our own, stock index futures are overseen by the Securities Bureau of the Ministry of Finance, which also oversees trading in stocks and options. In France, the SEC's counterpart, the Commission des Operations de Bourse, has authority over stock index futures trading on the MATIF, one of the fastest growing futures markets in the world, as well as over securities trading.1/

In the United Kingdom, the Securities and Investments Board ("SIB") has oversight over the SROs for both securities and stock index futures trading. Indeed, in the U.K. market even the options

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1/ Indeed, the MATIF is the partner of the CME in Globex, suggesting that the U.S. futures industry does not view the consolidated stock, options and futures regulatory system of France as representing an operational problem.

and futures SROs are proposing to merge to create an integrated market without market or regulatory fragmentation.

Commissioners Schapiro, Lochner, and I all believe that the current allocation of jurisdiction in the U.S. has serious weaknesses, and that the status quo is the least desirable of all alternatives. Commissioner Fleischman disagrees with this opinion.

B. If Congress were to adopt your proposal and transfer jurisdiction for stock-index futures to the SEC, how would you propose that the SEC should address the following issues [to the extent that the determination would involve Congressional action, what action would you propose that Congress take]:

Answer:

As a matter of record, the legislative proposals under discussion are those of President Bush and his Administration. I have supported enactment of these proposals, as has Federal Reserve Chairman Alan Greenspan and Treasury Secretary Brady.

Question B1:

Would you propose to ban or substantially restrict program trading strategies like index arbitrage or portfolio insurance?

Answer:

No. Enactment of the Administration's proposals to establish public oversight of margins and to extend appropriate anti-fraud standards to trading in stock index futures would eliminate any need to prohibit a specific trading strategy.

Question B2:

What risk disclosure would you propose be required for retail salesmen to provide on opening customer accounts to trade stock-index futures: a futures-style disclosure document as required under CFTC rules, or a securities style prospectus?

Answer:

Under the Administration's proposals, the risk disclosure requirements for stock index futures under the Commodity Exchange Act ("CEA") and applicable current regulations would remain unchanged.

Question B3:

Would you propose to require each exchange trading stock-index futures to create a separate clearinghouse for its stock-index markets separate from its other commodities, and for these clearinghouses to be unified? Would you propose to require each such exchange to register as a national securities exchange?

Answer:

No. It is important to note that under the Administration's proposal the Commission's function would be to administer provisions of the CEA as they apply to commodity clearing organizations. Consequently, the Commission does not contemplate requiring each exchange on which stock index futures are traded to register as a national securities exchange or to create a separate clearinghouse for stock index futures. Further, while the Commission believes that it would be desirable to coordinate the policies and procedures of separate clearinghouses from a perspective of promoting overall safety and soundness, the Commission does not believe that unification of separate clearinghouses is the only way to achieve this goal.

Question B4:

What registration requirement would you propose to apply to floor traders [locals] in the stock-index futures pits, and who would implement this requirement? As a general matter, would you propose that futures registrations under the National Futures Association be recognized by the SEC?

Answer:

Under the Administration's proposal, the registration provisions of the CEA would continue to apply, although the requirement to register with the CFTC with respect to activity in stock index futures would be changed to registering with the SEC. All valid futures registrations, including those for futures commission merchants ("FCMs") and associated persons of FCMs, in effect with the National Futures Association ("NFA") as of the effective date of the Administration's legislative proposal would be recognized by the SEC. Accordingly, all FCMs and associated persons of FCMs conducting a business in stock index futures and registered pursuant to CFTC rules with the NFA would be grandfathered and would be considered to be registered with the SEC. Further, FCMs and associated persons of FCMs would continue to register, as currently required under the regulations of the CEA, with the NFA.

I understand that certain proposals requiring registration of futures floor traders ("locals") are currently being considered by Congress. If Congress enacts these proposals into law as part of the CEA, under the Administration's proposal these new requirements

would automatically be applicable to stock index futures floor traders as well.

Question B5:

Would you propose to apply the anti-fraud provisions of the Commodity Exchange Act to stock-index futures trading, and would you propose that case decisions by the CFTC and federal courts would be considered as precedent in interpreting this provision?

Answer:

The current anti-fraud provisions of the CEA applicable to stock index futures customers are generally much weaker than the anti-fraud standards that protect customers in securities markets. For example, under the CEA there are not any "suitability" requirements, trading ahead of customer orders routinely occurs as part of "dual trading," there is no restriction against insider trading and the general anti-fraud standards embodied in Sections 10(b) (including Rule 10b-5) and 21 of the Securities Exchange Act of 1934 ("Exchange Act") do not exist in the index futures market.

To remedy the relative lack of protection against fraudulent and manipulative practices in the stock index futures market, the Administration's proposal would apply Sections 10(b) and 21 of the Exchange Act to trading in stock index futures. Among other things, Section 10(b) would, for the first time, apply insider trading provisions to stock index futures. At the same time, the Commission would be given rulemaking authority to adopt suitability standards and other traditional rules reasonably designed to prevent fraudulent, deceptive, or manipulative acts and practices with respect to stock index futures.

Under the Administration's proposal, the existing relatively weak anti-fraud provisions of the CEA would also continue to apply to trading in stock index futures, and the Commission would interpret these provisions of the CEA as they apply to stock index futures. In doing so, the Commission would examine the relevant precedent of the CFTC and the federal courts, in the same manner that we routinely examine different types of relevant precedent as we administer the different statutes under our existing jurisdiction, or that the Federal Reserve considers decisions of the Office of the Comptroller of the Currency ("OCC") or Federal Deposit Insurance Corporation ("FDIC") in interpreting banking laws under its jurisdiction.

Question B6:

Would you propose to require commodity pools to register as "investment advisors" or "investment companies" under relevant securities laws?

Answer:

No. The treatment of commodity pools would not change under the Administration's proposed legislation. Because stock index futures still would be regulated as futures contracts subject to the provisions of the CEA, as incorporated into the Exchange Act, commodity pools would not be deemed to be either investment advisers or investment companies as a consequence of their investment in stock index futures.

Question B7:

Would you propose to require computerized, tamper-proof audit trails for stock-index futures pits, as we have done in S.1729? If so, would you propose to extend this requirement to stock option markets to assure a "level playing field?"

Answer:

The accuracy of existing computerized transaction audit trails for the stock and options markets has been a high priority of the Commission since the 1970s. While we are pleased that Congress is finally considering requiring better audit trails for futures trading, we would have the same concerns for the stock index futures markets, where trade reporting and auditing capabilities have long been substantially inferior to systems routinely utilized in the stock and options exchanges.

Unlike stock index futures markets, the stock and options exchanges have long-established safeguards for the accuracy of audit trail information.

- For example, existing securities audit trails combine clearing information for both sides of each trade with last-sale information recorded by exchange personnel. As a result, not only are execution times and other information reported on the floor by both sides to each transaction, but regulatory staff on the floor capture essential information, including the size and price of each trade, at the same time that the trade occurs. The staff then promptly feeds this transaction-specific information into computerized systems that maintain

this data for surveillance and investigatory purposes and that disseminate essential last-sale information to the investing public. Thus, there is a verification check built into securities exchange audit trails.

- In the major stock index futures markets such as the CME and CBOT, however, there is no last-sale reporting tape. Instead, these markets have only a price-change register that reflects price changes not directly attributable to specific transactions. To partly compensate for the lack of this vital information, the CME and CBOT rely on systems that allocate estimated execution times for trades by reviewing a series of trade data, including times on the price-change register. This "guesstimating" system is often of limited, if any, utility for investigatory and law enforcement purposes, especially when the same price occurs at different times within a time span in which the computer estimated that the transaction probably occurred.

- In the stock and options audit trails, execution time stamps are required to be on all order tickets, including tickets for trades by floor traders such as market makers. On the CME and CBOT, as well as

all other futures exchanges, only a limited portion of certain types of trades done by floor traders currently are required to have time stamps. As a result, exchange personnel attempting to reconstruct trading by these parties must use a variety of other pieces of information to attempt to verify the accuracy of execution times that are estimated, not recorded. By contrast, exact times are available for stock and options trades.

- At the stock and options exchanges, the extensive array of existing automated order-routing (and, in some cases, order-execution) systems already produce computerized records of a sizeable portion of trades. For example, the New York Stock Exchange has various automated order-routing and order-processing systems such as Designated Order Turnaround ("DOT" or "SuperDot"), Opening Automated Report Service ("OARS"), and the Specialist Electronic Display Book ("EDB"). In 1989, approximately 80% of all orders on the NYSE were routed through SuperDot. This, in turn, assists in maintaining the accuracy of audit trails. It is our understanding that the CME and CBOT still are developing possible automated order-routing or order-execution systems.

. The Commission would conduct a careful analysis of the operations and capabilities of the stock index futures markets to determine to what extent the safeguards of the stock and options audit trails could be applied to the pit-trading environment of the futures markets. Certainly, further expansion of automated systems, enhancements of safeguards such as time stamping, and overall improvements in accuracy rates would continue to be high priorities of the Commission for all equity and equity-derivative markets.

Question B8:

Would you propose to allow state securities administrators to play a role in regulating the retail marketing of stock-index futures to public customers? or to sue firms defrauding customers?

Answer:

Under the Administration's legislative proposal, state securities administrators would not have any different role in regulating the retail marketing of stock index futures to public customers than they do under the current regulatory scheme.

Question B9:

Would you propose that the SEC conduct economic purpose tests of new stock-index products to assure that they are usable for commercial "hedging" or "price-basing" and that purely speculative instruments are not allowed?

Answer:

Under the Administration's proposals, the SEC would conduct the applicable statutory review under the CEA for new stock index futures products, including an economic purpose test.

Question B10:

What structure would you propose for the SEC to coordinate with the Commodity Futures Trading Commission on inter-market/inter-agency issues or enforcement matters involving exchanges or firms which trade simultaneously both SEC-regulated stock-index futures and CFTC-regulated futures in other commodities.

Answer:

The largest area of inter-market enforcement problems is that involving trading in the stock, options and stock index futures markets. Today, numerous firms and exchanges trade products that are economic substitutes for one another under different rules overseen by different agencies. This fragmentation would be eliminated by the Administration's bill, thereby permitting much more effective investigations of intermarket fraud throughout the single economic market of stocks, options and stock index futures.

The number of fraud cases that might involve the same firm trading stocks (or stock index futures) and cotton futures under the Administration's bill would be no different than it is today, and it would be handled in the same manner as it is today. However, there are far fewer such cases than enforcement matters crossing between the stock, options and stock index futures exchanges and markets every day, each of which raises issues of monitoring potential intermarket fraud and manipulation. In this

area of numerous potential problems the Administration proposal will create a "single cop on the beat" to replace weak enforcement due to divided jurisdiction.

Question B11:

Would you propose to direct the SEC enforcement staff to bring cases directly against floor traders in the stock-index futures pit who violate trading rules rather than leaving this function solely to the exchanges [as I understand is the SEC's current practice with regard to securities exchanges]? If so, would the SEC enforcement division require significant increases in staff levels?

Answer:

Under the Administration's proposal, the Commission would be authorized to enforce provisions of the CEA with respect to participants in stock index futures markets. The Administration's proposal would also provide new statutory bases for attacking fraud in the stock index futures market. For the first time, transactions in stock index futures would be subject to the anti-fraud provisions of Section 10(b) of the Exchange Act. In addition, the Commission would be granted new rulemaking authority to prevent fraudulent, deceptive, or manipulative acts or practices with respect to stock index futures similar to its existing broad authority with respect to stock and stock options. These changes are intended to provide long overdue enhanced protection against fraud to users of the stock index futures markets.

The Commission supports the concept of self-regulation in the markets. Activities of the SROs, coupled with Commission oversight, has been central to the administration of the federal securities laws for nearly 60 years. If the Administration's

proposal is enacted, the Commission expects to work closely with SROs in the futures markets, as it does with the corresponding organizations in the securities markets, to ensure fair and efficient regulation and oversight. In this regard, the boards of trade would continue to exercise day-to-day authority over their members and persons associated with them. They would also generally have responsibility for enforcement of the trading rules applicable to their members. In appropriate cases, however, the Commission would also exercise its authority to investigate, and to take enforcement action against, violative conduct in these markets. This would include violative conduct by floor traders in the stock-index futures pit.

As in its regulation of the securities markets, Commission determinations as to which matters merit Commission intervention would necessarily be made on a case-by-case basis. The Commission would generally consider such factors as the involvement of persons who are not subject to the jurisdiction of the SRO (in which event complete relief would not be available through action by the SRO acting alone), and the importance of the matter to the overall public interest in integrity of the trading markets.

The consolidation of jurisdiction under the Administration's proposal would likely add to the number of investigations by the Commission's Division of Enforcement, which is currently being expanded to meet the challenges of financial regulation in an increasingly global environment. The added responsibilities of the proposed legislation may make desirable some increase in resources

for enforcement beyond those already planned, although this added responsibility could be absorbed within existing staff. Indeed, the SEC's current staffing for enforcement matters exceeds the entire staff of the CFTC. However, unlike the CFTC, which is largely funded by the taxpayers, the SEC budget is more than fully offset by industry fees. Therefore, modest expansion of the SEC's enforcement staff would not result in additional taxpayer costs.

Question B12:

Would you propose to require that customers or traders maintain separate accounts for trading futures in stock indices apart from futures in other commodities? Should funds in customer accounts be subject to segregation requirements as under current commodity laws?

Answer:

The Administration's proposal would leave all CFTC and board of trade rules presently applicable to stock index futures trading in place. At present, we see no reason why the current account recordkeeping requirements under the CEA should be altered. Similarly, since the provisions of the CEA would continue to govern transactions in stock index futures, customer accounts would continue to be subject to segregation requirements.

Question B13:

Would you propose to require that public members sit on exchange disciplinary committees when they hear cases against floor traders, particularly exchange "insiders?" If so, would you consider extending this rule to securities markets?

Answer:

Under the Administration's proposal, the existing provisions of the CEA would be controlling as to disciplinary committees hearing stock index futures cases.

The Commission is always willing to consider means to strengthen and enhance the SRO disciplinary process. Accordingly, if experience suggested that having public members sit on exchange disciplinary committees was useful and effective, then the Commission would consider extending this concept to the securities markets.

At the present time there is already a high degree of public representation on the board of governors and various committees of the securities markets. Sections 6(b)(3) and 15A(b)(4) of the Exchange Act require that one or more of the directors of registered national securities exchanges and securities associations must be representatives of issuers and investors. In fact, the Boards of the New York Stock Exchange and American Stock Exchange are almost evenly divided between public and non-public representatives. These sections also require that the exchange or association assure a fair representation of its members (e.g. upstairs firms as well as floor traders) in the selection of its directors and in the operation of the entity.

The current New York Stock Exchange Board of Directors, for example, consists of 24 members, twelve of whom are public directors. These public directors become involved in disciplinary proceedings of exchange members when a member firm appeals the

determination or penalty imposed by a hearing panel in a disciplinary action in which the member firm has been adjudged guilty. The other national securities exchanges, as well as the National Association of Securities Dealers, provide for similar public involvement in the review of disciplinary actions against their member firms.

Question B14:

As of today, the Chicago Mercantile Exchange's margin requirements for its futures contract on the Standard and Poor 500 index are as follows:

-- initial margin for speculative positions: $20,000 per contract, or about 12 percent.

-- maintenance margin and initial margin for commercial hedge positions: $7,500, or about 5 percent.

Do you believe that these margins in effect today are adequate given current market conditions and current levels of securities margin? If not, how high would you raise them?

Answer:

The adequacy of current margins for different stock index futures contracts is purely irrelevant. When the Reagan Administration and Congress considered the adequacy of margins in 1988, following the October 1987 market crash, the futures exchanges maintained margins for speculative accounts even higher than those in effect today. At that time, the President's Working Group decided not to recommend legislation on margins to Congress, largely on the basis that margins then in effect were adequate to meet prudential concerns. Once this decision was made and public debate over margins ended, the CME slashed margin levels until they

stood at barely more than 2% last October 13 when the market again fell precipitously. Given this recent history, it would take an extraordinary level of naivete or cynicism to allow the current margin levels of the futures exchanges to influence the debate over the need to establish public oversight over SRO margin decisions.

Unless current law is changed and some agency accountable to the American public is given oversight authority over margins set by the exchanges, there is nothing to prevent the exact same process from occurring in the future. By contrast, government authority already exists in the U.S. options market, and in all major foreign stock index futures markets.

If the Administration's proposal was enacted, I believe that there would be significant sympathy in the Commission to the view expressed by President Corrigan of the Federal Reserve Bank of New York, who recently observed:

> "I am still not at all sure that margins for financial futures are as high as they should be, at least from the vantage point of their role as a financial shock absorber helping to ensure the safety and integrity of the clearing and settlement mechanisms for such markets ... A good case can be made that margins should be high enough in the first instance that they don't need to be raised in emergency situations ...
>
> I believe that margins in many financial-type futures instruments are typically -- if not systematically -- too

low. In the case of the S&P 500 contract, for example, it seems to me that a significantly higher margin -- perhaps as high as 15 percent or so -- is always called for. I also have serious doubts as to the wisdom of leaving the day-to-day establishment and administration of margins to the exchanges. In saying this, I know that there are many who would take serious objection to this suggestion, primarily on the grounds that such higher margins would increase transactions costs and reduce liquidity in these markets. There may or may not be something to that argument but even if it were valid, it seems to me that achieving a somewhat deeper financial cushion in the clearing and settlement mechanisms associated with these markets may be worth these costs, especially to the extent that there is a tendency for such liquidity to be illusory in times of stress."

-- Remarks before the 62nd Annual Mid-Winter meeting of the New York State Bankers Association, January 25, 1990

At the same time, if the Administration's proposal were passed, I would encourage the Commission to expand immediately existing cross margining programs to reduce the effective margin levels for non-leveraged hedge positions.

II. CFTC Exclusivity

In your testimony, you support the Administration's proposal to modify the Commodity Exchange Act "exclusivity" clause. Where do you intend to draw the line? For instance:

Question 1:

CFTC "exclusivity" now means that only one Federal agency, the CFTC, can today regulate trading on, say, the crude oil futures contract at the New York Mercantile Exchange. Would you propose to allow several federal agencies, say the Departments of Interior and the SEC, to simultaneously issue rules affecting this market alongside the CFTC? Or would you allow just one agency at a time?

Answer:

No. The Administration's exclusivity proposal would not allow several federal agencies to issue rules affecting a futures product. Instead, the Administration's proposal would modify the exclusivity clause to allow instruments that are securities to trade in the securities markets, subject to the regulatory authority of the SEC, even if they have some elements of "futurity." If such instruments also qualify as future contracts, they could also trade on a designated contract market, subject to the sole regulation of the SEC (in the case of stock index futures) or the CFTC in the case of crude oil or other futures. In either case, however, such instruments would be subject to the regulatory authority of only one agency -- either the SEC or the CFTC, depending on the form of the instrument and the market in which it was traded.

Question 2:

The "index participation," to which you refer, was approved to trade on a regulated national securities exchange? Would you propose to allow futures contracts to be approved if they are not

going to trade on any regulated exchange: neither a futures exchange nor a securities exchange?

Answer:

Hybrid securities products, such as index participations, that might be considered to be futures would not be confined to exchange trading, since the securities laws provide ample regulation of securities trading in both exchange and over-the-counter markets.

Question 3:

a) Would you propose to allow a futures contract on, say, crude oil to trade under the sole or principal regulation of a state government?

Answer:

No.

b) Or of a non-financial federal agency like the Energy Department [or timber futures under the U.S. Forest Service]?

Answer:

No. While colorful, these examples are obviously not within the scope of the Administration's proposals.

Question 4:

Would you propose to allow futures exchanges under CFTC regulation to trade non-futures instruments such as securities options, or to trade futures contracts on individual stocks?

Answer:

No. Under the Administration's proposal, the regulatory framework of the CEA would not be changed; administration of the provisions of the CEA with respect to stock index futures simply

would shift from the CFTC to the SEC. Therefore, while futures exchanges would not lose any authority they have today regarding the types of instruments they may trade, they would not gain any authority either. However, this subject would be examined as part of an 18-month study of desirable changes following this legislation. Conceptually, I favor the broadest possible freedom for exchanges under comparable regulatory safeguards to trade competing products.

Question 5:

Would you propose that the anti-fraud and anti-manipulation provisions of the Commodity Exchange Act apply to futures contracts which are exempted from CFTC "exclusive" jurisdiction?

Answer:

Under the Administration's proposed legislation, securities that involve some hybrid feature that could be construed to involve some degree of futurity and that could cause them to be deemed futures could trade under the established system of securities regulation, without the necessity of a 3-year lawsuit to decide whether the product contained some elements of a futures contract. The much stronger anti-fraud and anti-manipulation standards of securities law would provide customers of these products with strong anti-fraud and anti-manipulation protection. As is the case today, a hybrid product approved for trading on a futures exchange would be subject to the anti-fraud and anti-manipulation provisions of the CEA.

The CHAIRMAN. Thank you very much, Chairman Breeden. I appreciate your testimony and willingness to be here.

Chairman Gramm, we look forward to hearing from you.

STATEMENT OF WENDY L. GRAMM, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION, WASHINGTON, DC

Dr. GRAMM. Thank you. Mr. Chairman, Senators, I welcome the opportunity to appear before this committee to present the views of the Commodity Futures Trading Commission (CFTC) regarding futures regulation and jurisdictional issues.

Our job as policymakers is to ensure fair and open markets, financial integrity, investor confidence, and international competitiveness for all U.S. financial markets, including securities and futures. The issue before us today is the type of regulatory structure that best can accomplish these goals. In recent months——

Senator BOSCHWITZ. Mr. Chairman, may I ask this witness, too, if there is any sense in my trying to follow her prepared testimony?

Dr. GRAMM. You have a 39-page prepared testimony. I do have some copies of my shorter version.

Senator BOSCHWITZ. You have copies of it?

Dr. GRAMM. Yes.

Senator BOSCHWITZ. Could we tell the staff to bring them up here?

The CHAIRMAN. The 39-page one, like some of my very long questions, will also be part of the record.

Dr. GRAMM. I am sure you don't want to hear me read the 39 pages.

The CHAIRMAN. Oh, I would enjoy it, but I have the feeling that Chairman Greenspan would probably never again accept any invitation from me to anything. [Laughter.]

And I wouldn't blame him.

Go ahead, Dr. Gramm.

Dr. GRAMM. This is much shorter.

PROPOSALS HAVE SURFACED TO REDRAW THE JURISDICTIONAL LINES BETWEEN THE COMMODITY FUTURES TRADING COMMISSION AND THE SECURITIES AND EXCHANGE COMMISSION

In recent months, several proposals have surfaced to redraw the jurisdictional lines between the Commodity Futures Trading Commission and the Securities and Exchange Commission. Three alternatives have been proposed: shift stock-index futures jurisdiction from the CFTC to the SEC; shift jurisdiction over all financial futures to the SEC; or merge the two agencies.

THE CFTC IS CONCERNED THAT THE PROPOSED CHANGES WOULD DAMAGE THE WORLD LEADERSHIP POSITION OF THE U.S. FUTURES MARKETS AND NOT ENHANCE THE POSITION OF OUR CAPITAL MARKETS

These proposals represent a radical restructuring of our jurisdiction. The reasons given in support of any jurisdictional change do not withstand objective scrutiny. The CFTC is concerned that the proposed changes would damage the world leadership position of the U.S. futures markets and not enhance the position of our cap-

ital markets. The commission is therefore vigorously opposed to each of these jurisdictional proposals.

Furthermore, the Commission is concerned that our reauthorization legislation, which includes needed market reforms, is being held up in the Senate because of this continuing and unnecessary jurisdictional battle.

OUR SECURITIES AND FUTURES MARKETS FACE IMPORTANT ISSUES

To be sure, our securities and futures markets face important issues: the long-term decline in retail securities brokerage business, infrequent episodes of abrupt stock market declines, and intermarket issues like systemic risk in clearing, settlement, and payments. However, these issues do not exist because of the current regulatory boundaries or because there are two regulators, nor will a change in jurisdiction resolve them. In fact, any type of quick-fix regulatory shift will only raise false hopes, increase regulatory complexity, raise capital costs, and diminish the liquidity, efficiency, and competitiveness of U.S. futures markets.

ARE THERE ANY CREDIBLE ARGUMENTS FOR SHIFTING CFTC JURISDICTION TO THE SEC OR FOR MERGING THE TWO AGENCIES?

Are there any credible arguments for shifting CFTC jurisdiction to the SEC or for merging the two agencies? My prepared statement includes a point-by-point analysis of the so-called problems that have been put forth, but let me touch on a few issues now.

We are told that the securities market and the stock-index futures market constitute one market. That is no surprise to the CFTC. All futures markets are linked to their underlying cash market. That does not mean, however, that these linked markets must be subject to a single regulator with a single rulebook. In fact, merging the cash market regulator, which tends to favor stable or higher prices, with the futures regulator, which must remain price neutral, would institutionalize the very kind of regulatory conflict of interest that Congress sought to avoid in creating an independent CFTC back in 1974.

As for margins on volatility, economists have searched for, but not found, a systematic relationship between futures margins and stock market volatility. Chairman Greenspan's testimony on March 29 summarized the results of this research:

> All the analytical tools we have brought to bear have failed to find any such relationship. Efforts to restrain volatility by imposing more restrictions on particular markets or instruments could have unintended effects resulting in significant costs on the system and a shifting of transactions activity offshore.

We are also told that because margins between stock and futures are not harmonized, highly leveraged futures traders are forced to sell to meet margin calls, causing liquidity to vanish. There is no supporting evidence that the stock-index futures market is more highly leveraged than the stock market. A cash portfolio position hedged with a futures position is not leverage, regardless of the level of futures margin. Moreover, the stock-index futures market is used predominantly by institutions to hedge their cash market portfolio.

The argument suggests further that highly leveraged futures traders must close their positions on volatile days to meet margin calls, prompting a decline in open interest for the futures contract as a whole and particularly for the affected group. An examination of the magnitude of open interest in the S&P 500 stock-index futures contract on high-volatility days contradicts the supposition that a margin call selloff exacerbated the market decline. On October 19, 1987, for example, also on October 13 and 16 of 1989, open interest at the day's end was higher than on the previous day.

Another current argument is that separate regulation of securities and stock-index futures encourages intermarket frontrunning and other intermarket trading abuses. While frontrunning is possible, it is not encouraged by separate regulators nor does it go undetected because there are two regulators. The fact is that both securities exchanges and futures exchanges have recognized the problem of intermarket frontrunning and have recently developed cooperative surveillance techniques to detect it. At this point there is no concrete evidence that intermarket frontrunning has posed a significant threat to market integrity. Both the CFTC and the exchanges are working to detect and deter any problem, and I believe that this can be accomplished within the existing regulatory structure.

As to the argument that two regulatory agencies hinder the United States in international negotiations, I would again respond that the evidence speaks for itself. To my knowledge, neither the SEC nor the CFTC has been impeded in its dealing with foreign regulatory authorities because of our separate jurisdictions.

Furthermore, there is no uniformity of regulatory structure among foreign regulators. A careful examination reveals wide disparities of regulatory approaches. Our markets have prospered under the current regulatory structure, and therefore we see no reason to change our system to parallel systems of less experienced foreign authorities.

Finally, I must say that the most surprising argument now being made is that the CFTC and the futures industry stifle innovation; in particular, index participation products, or IP's, as they are commonly called. Review the record, and you will find that innovation is embedded in the fabric of the futures industry and that the commission encourages it, as it did with IP's. The commission worked hard to resolve the regulatory issues that blocked the introduction of IP's.

But let's be clear about one thing: An IP is not some novel form of security, and it is certainly not used for capital formation. There is no asset underlying the IP, none at all. The plain truth is that an IP, as it was proposed in the United States, is a futures contract and, as such, must be approved by the CFTC in order to trade.

Only the name is the same for the product trading on the Toronto Stock Exchange and the IP product originally proposed by the Philadelphia Stock Exchange. According to the Ontario Securities Commission, the Toronto 35 Index Participation Units, TIP's, as they are called, are units of a trust. The Toronto TIP's represent ownership of actual Canadian stocks held by the trust, whereas the United States IP's had no underlying assets. So TIP's are trading as a security in Toronto because they are a security.

THE COMMISSION BELIEVES THAT THE CASE FOR SHIFTING JURISDICTION OVER STOCK-INDEX FUTURES TO THE SEC OR FOR MERGING THE TWO AGENCIES SIMPLY HAS NOT BEEN MADE

In sum, the Commission believes that the case for shifting jurisdiction over stock-index futures to the SEC or for merging the two agencies simply has not been made. Jurisdictional gerrymandering will disrupt our markets, the most effective in the world. Proposals to permit the SEC to administer parts of the Commodity Exchange Act or to regulate stock-index futures would only increase regulatory costs and confusion. Eliminating exclusive jurisdiction could result in regulatory chaos by allowing futures, which all have the same economic purpose, to be regulated under multiple and different regulatory systems. It would invite the States or other Federal regulators to impose rules, sometimes even conflicting rules that could undermine the efficiency of futures markets as international hedging and price-discovery instruments.

Market users who now trade with confidence and assurance in a familiar market system and under long-established rules would face a transition period fraught with regulatory uncertainty, and an 18-month study, begun after radical regulatory shifts occur, would only prolong the uncertainty.

The futures markets would become less liquid and efficient and ultimately could be replaced by overseas markets which could be perceived as more active and stable.

THE IMPACT OF THE PROPOSED JURISDICTIONAL CHANGE ON THE CFTC WOULD BE ENORMOUS

Finally, the impact of the proposed jurisdictional change on the CFTC would be enormous. As you well know, financial regulatory agencies are having a hard time recruiting and retaining experienced personnel. Splitting off stock index or financial futures from the CFTC would result in a loss of some of our most experienced personnel, which would damage agency morale and threaten our ability to oversee the remaining markets within our jurisdiction.

Under the existing regulatory structure, the United States has the most liquid, most innovative, and largest futures markets in the world. It is high time we returned to the work of keeping our financial markets strong and preparing them for the challenges ahead. International competition in Europe and the Pacific Rim is already here, and there is much we must do to ensure that our statutory goals are met in an increasingly global and automated market. In order to meet these goals successfully, we must enact the provisions in our reauthorization bill to enhance our ability to oversee our domestic marketplace more effectively as well as to police for international fraud.

Thank you very much.

The CHAIRMAN. Thank you very much, Dr. Gramm, and I appreciate your testimony.

[The prepared statement of Dr. Gramm follows:]

Statement of

Dr. Wendy L. Gramm

Chairman

Commodity Futures Trading Commission

Before the

Senate Committee on Agriculture,

Nutrition, and Forestry

May 8, 1990

Mr. Chairman, I welcome this opportunity to appear before this Committee to present the views of the Commodity Futures Trading Commission (CFTC) regarding futures regulation and jurisdictional issues. Those of us charged with making policy choices must be careful to distinguish fact from rhetoric. The legitimate goal of international competitiveness for all United States markets should not be confused with the parochial claims of competing domestic market interests. And we must keep in mind the very different functions served by capital formation and risk-shifting markets.

Let me turn to the issue before us today -- whether to redraw the jurisdictional lines between the CFTC and the Securities and Exchange Commission (SEC) in an attempt to (1) diminish stock and derivative market volatility,

(2) facilitate innovation, and (3) better police our markets against manipulation.

The Commodity Futures Trading Commission opposes any change in jurisdiction, including a shift of jurisdiction for stock index futures, financial futures, or a merger of the SEC and the CFTC. A change in CFTC jurisdiction will not solve any of the real issues our financial markets face today. Furthermore, the Commission believes that, unfortunately, our reauthorization legislation, which includes much needed market reforms, is being held up in the Senate because of a continuing and unnecessary jurisdictional battle.

To be sure, financial markets and their regulators face some important issues. These issues include the long-term decline of United States prominence in world equity markets, the long-term decline in retail securities brokerage business, short-term stock market volatility, and intermarket concerns, such as circuit breakers and the systemic risk in clearing, settlement, and payments. These issues do not exist because of the jurisdictional boundaries between the CFTC and the SEC -- nor will a change in jurisdiction resolve them.

Under the existing regulatory framework, the U.S. has the most liquid, most innovative and largest futures markets in the world. That framework has allowed futures markets to

successfully adapt to economic change and will continue to do so. In 1960, 3.9 million futures contracts were traded in the United States. By 1980 that number had grown over 20 fold -- to 92 million contracts. During those 20 years, futures markets created new contracts to respond to rapidly changing economic conditions that came with floating exchange rates, rising interest rates and an increasingly global marketplace. By 1989, over 267 million contracts were traded, most recently reflecting growth in stock index futures and in the Eurodollar futures markets. In 1989, agricultural futures accounted for over 20 percent of total trading volume and was 68 per cent more than total futures volume during the Commission's first year, 1975.[1]

This growth has not been accidental. For well over a century, American farmers and agricultural processors and merchants have realized the importance of futures markets for efficient price discovery and hedging. They discovered that futures and cash markets were linked and that this linkage allowed them to use futures markets to hedge price risk and lock in the price of grain in the months ahead. More than a century later this "discovery" became apparent to financial managers who sought ways to hedge price risk for their cash market inventories and portfolios. Today, futures markets are successfully used by

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[1]Futures Industry Association, Inc., 1990. Futures Contracts Traded by Commodity Group.

producers, merchandisers, commercial institutions, institutional investors, fund managers and many others to manage the risk associated with changing cash market prices.

Today, the CFTC regulates more than 80 active futures contracts. Twenty-seven of these, or about one-third, are based on agricultural commodities, 19 are based on precious metals, energy and other physical commodities and 35 are financial futures--interest rate, stock index and foreign currency contracts. Let me stress two important characteristics that all these commodities share despite differences in pricing structure and economic fundamentals: (1) in each case, the cash market is linked to a futures contract, and (2) such contracts are traded and regulated in the same way.

The point is not that the futures market is linked to the stock market--all futures markets are linked to a cash market. The fact that these markets are linked, however, does not mean that cash and futures markets serve a single purpose, should be regulated in the same way or by the same regulator. Nor does it mean that the separate components can operate safely or successfully under the same rules. Each futures market serves a different purpose from its underlying cash market.

Indeed, in 1974 Congress recognized this truth and separated agricultural futures regulation from agricultural cash market

regulation. When Congress established the CFTC as an independent agency, it recognized not only the functional differences between the cash and futures markets, but also the potential conflicts of interest that could arise. As the General Accounting Office observed at the time:

> A potential conflict of duties and responsibilities might exist if the Commission were located within the Department of Agriculture, and chaired, on a permanent basis, by the Secretary of Agriculture, who is charged by law to influence and maintain the prices of many of the commodities traded in the futures markets. (H.R. Rep. No. 93-975 at 60).

The perceived policy goal of the USDA for stable or higher agricultural cash commodity prices is similar to the SEC's interest in stable or higher stock prices. However, the futures regulator must be insulated from any price bias in order to maintain price neutrality. A fair and open hedging market must be price neutral. Futures regulation cannot favor longs over the shorts. Unlike the SEC, the CFTC does not have an uptick rule for short selling. Nor does the CFTC have a rule permitting traders to prevent or retard only falling prices as does the SEC for "stabilizing" market prices of new stock issues. In fact, the CFTC can take emergency action when prices do not reflect the forces of supply and demand, regardless of whether prices are rising or falling.

Congress has tailored a regulatory framework to facilitate the special purposes and functions of the futures markets. The Commodity Exchange Act reflects the special risk-shifting

functions of futures transactions and provides market and customer protections distinct from those applicable to securities and other cash markets.

Futures contracts must undergo an approval process before they are allowed to trade that has no counterpart in the securities laws. Exchanges seeking to trade a new contract must first demonstrate that trading "will not be contrary to the public interest," that is, that it will serve an "economic purpose." In practical terms, the contract must serve a price basing or hedging use on more than an occasional basis. The Commission reviews each proposed futures contract to determine whether the exchange has demonstrated adequately that the proposed contract serves an economic purpose, has addressed the possible susceptibility of the contract to manipulation, and that other relevant public interest concerns have been satisfied.

In addition, the Commodity Exchange Act requires that customer funds be segregated; authorizes the Commission to establish a "large trader" reporting system; provides authority to impose speculative position limits; and establishes a customer reparations forum at the Commission. These aspects of the futures regulatory system also find no counterpart in the securities regulatory system.

Current Jurisdiction -- Is It an Obstacle to Effective Regulation?

United States futures markets serve as models for other countries developing agricultural, energy and financial futures and options products, just as the CFTC serves as a model for other countries developing futures market regulatory systems.

The success of these markets and the existing system is borne out by the evidence of market performance and regulatory achievements. There is no evidence that current jurisdictional boundaries impede successful regulation -- whether done independently or in cooperation with other agencies. Let's examine the record.

1. Trade Practice Surveillance. In recent years, the CFTC has taken significant action involving trade practice surveillance:

- o One-minute Audit Trail. We required exchanges to implement one-minute audit trail systems. These systems allow prompt reconstruction of trading activity including essential information about both sides of each trade. This audit trail permits futures exchanges and the Commission to reconstruct and analyze trading patterns quickly. This system was instrumental in reconstructing trading activity immediately after the October 1987 market crash and after other high volume

trading days. Nothing comparable to it exists in the securities industry.

- Improved Floor Surveillance and Trade Practice Investigations. We monitor trading through trade practice investigations and direct "pit patrols." We have increased staff presence on exchange floors and enhanced our electronic database system to assist in investigations.

- Public Exchange Rule Enforcement Reviews. CFTC rule enforcement reviews are part of our trade practice oversight program. This program encourages exchanges to remedy deficiencies promptly.

2. Trade Practice Rules. The CFTC also acts expeditiously when problems occur. For instance, within the last year, we have taken significant regulatory actions based upon information obtained in the recent Chicago undercover investigations and through other regulatory activities.

- Improved Accuracy and Integrity of Audit Trails. We wrote new rules to improve the accuracy and integrity of exchange audit trails by requiring improved recordkeeping procedures for audit trail systems.

- **Restricting Certain Exchange Members from Committee Service**. We wrote a new rule to prohibit persons with significant disciplinary histories from serving on specified exchange committees and boards.

- **Dual Trading**. We completed a comprehensive study of the effects of dual trading which prompted proposed rules to implement a plan to restrict dual trading.

- **Broker Associations**. We completed a study of broker association practices which prompted proposed rules requiring registration of these associations so that their activities may be better monitored.

3. Clearing and Settlement. The CFTC has also addressed clearing and settlement issues arising out of the 1987 market break.

- **Settlement Bank Agreements**. We monitored the development of new agreements designed to clarify the obligations of banks to futures clearing organizations in making margin settlements.

- **Reduced Reliance on Letters of Credit**. We encouraged futures exchanges to increase the liquidity of clearing organizations' guarantee funds by reducing reliance on

letters of credit and by developing procedures to prevent excessive concentrations of letters of credit issued by any one bank.

- Improved Exchange Margin Payment Procedures. We encouraged development of procedures to pay out and collect margin on a routine intra-day basis, thereby reducing variation margin flows at the daily morning settlement.

- Improved Information Sharing. We encouraged all futures clearing organizations to enter into a Market Information Sharing Agreement for the routine electronic sharing of margin pay and collect information on a daily basis. In October 1989, the Options Clearing Corporation, the clearing organization for all equity options, also entered into this agreement.

- Improved Financial Surveillance. We are developing a database using CFTC large trader reports and open position data to monitor the effect of price movements on FCM capital across all futures markets and for other financial surveillance purposes.

4. International Trading. The CFTC has also addressed issues involving the sale of foreign futures and options to U.S. customers.

- **Foreign Futures and Options**. We have extended existing CFTC customer protection rules to United States purchasers of foreign futures and options from five different jurisdictions. Certain persons located outside the United States are permitted to seek an exemption from some CFTC rules if they comply with their foreign regulatory program and if the foreign regulators agree to share financial and trade information with the CFTC.

5. Market Innovation. We have taken significant steps to support market innovation:

- **Trading Methods**. The Commission approved Globex, a screen trading system proposed by the Chicago Mercantile Exchange to initiate 24-hour cross-border trading. In our review, we considered access to Globex terminals, order entry and execution, clearing and margin, the CME-Reuters relationship, compliance systems, computer security, systems failures, and the applicability of United States law. A similar review of Aurora, a computerized trading system proposed by the Chicago Board of Trade, is also under way.

- **Off-Exchange Instruments**. In addition to encouraging innovations in exchange-traded products, in 1987 the CFTC established a task force to review and

accommodate, within the framework of the existing Commodity Exchange Act, recent innovations in the area of off-exchange hybrid debt and depository instruments. We have succeeded in achieving this goal through rulemaking, statutory interpretation, a policy statement, and no-action letters. We worked with other agencies to avoid litigation, avoid regulatory gaps, and reduce regulatory uncertainty that existed in these markets -- uncertainties that stood as an impediment to further innovation.

Regulatory Coordination

The CFTC's programs are coordinated with other government agencies in a variety of ways. Since all futures trading involves hedging and price discovery, the CFTC keeps apprised of cash market commercial practices for many different commodities as it approves contracts and monitors trading. This requires frequent contact with regulators of diverse cash markets. Thus, the CFTC has information-sharing arrangements with the Departments of Agriculture, Energy and Treasury, and since the advent of stock index futures, with the SEC. Through the use of its large trader reporting system, the CFTC conducts market surveillance independently and in coordination with other agencies and self-regulatory organizations.

With regard to the financial markets specifically, the CFTC, SEC, Treasury Department, and Federal Reserve System staffs meet periodically to review upcoming contract liquidations and share other information about trading activity. The CFTC and SEC coordinate intermarket trading issues through a number of means, including (1) meetings with the Intermarket Surveillance Group, composed of the securities and futures exchanges that trade stock index products; (2) participation in the Intermarket Network for Futures, Options, and Equities, an open dedicated phone line designed to simultaneously share important market news and developments among the exchanges; and (3) through agency surveillance staff contact to share data and information concerning securities and stock index futures markets as the situation warrants.

On several occasions, the CFTC and SEC staffs have conducted joint interviews with major traders to determine the nature of various trading strategies and their impact on the markets. The New York Stock Exchange and the Chicago Mercantile Exchange also now exchange certain confidential trade information on a routine basis. The Chicago Board of Trade is expected to conclude a similar agreement with the New York Stock Exchange. Sharing market data enables the exchanges to perform regular, computerized surveillance for intermarket frontrunning and other trading abuses.

Financial surveillance is also being coordinated. The Joint Audit Committee, comprised of representatives of the futures exchanges and the NYSE, distributes futures market auditing responsibilities among all participants. In addition, the CFTC and SEC have developed and authorized consistent capital requirements for brokers. Also, the two agencies have permitted members of both securities and futures exchanges to file certain SEC financial reports with the CFTC instead of completing duplicative reports. Further coordinating initiatives are in progress.

The CFTC has worked with other agencies and the President's Working Group on Financial Markets to address clearing and settlement issues. We have coordinated with the SEC in approving two intermarket cross-margining programs. Cross margining permits persons who trade in related markets to calculate their margins based on their combined risk exposure in both markets. We also fostered development of an information-sharing system in which all futures and securities clearing organizations can participate to provide a basis for risk assessment across markets.

In sum, the present allocation of jurisdictional responsibility has not been an obstacle to effective regulation. This is not to say that existing laws are perfect. Important and necessary market reform legislation for both the securities and

futures industries is presently pending before Congress. In this regard, Mr. Chairman, I echo your call that the Senate act promptly to pass S. 1729, the Futures Trading Practices Act of 1989. The CFTC and the public interest require enactment of needed statutory improvements to sustain confidence in the markets and to enhance existing regulatory systems. What has not been demonstrated, however, is the need to shift jurisdiction from the CFTC to the SEC or to merge the agencies.

No Case for Change

Despite the fact that no substantive justification for a shift in CFTC's jurisdiction has been made, we continue to hear a call for jurisdictional change. All the alternatives suggested: 1) shift stock index futures jurisdiction from the CFTC to the SEC, 2) shift jurisdiction over all financial futures to the SEC, and 3) merge the SEC and the CFTC into some new super agency, would result in a radical restructuring of current regulatory systems. Yet fundamental questions, that would ordinarily precede such a radical restructuring, remain unanswered. These questions include:

- What problem is the proposed shift in jurisdiction supposed to fix?
- What would such a shift in jurisdiction accomplish?
- What specific policies will be altered as a result of a change in jurisdiction? In other words, what would be done differently? And how?
- What are the possible unintended consequences of a jurisdictional restructuring?

Recently, we have been told that a handful of problems exists and that deficiencies exist in the current regulatory system. These claims include:

- Stock index futures and related trading strategies have driven the individual investor from the stock market and impaired its capital raising function.
- Trading stock index futures causes increased stock market volatility.
- Margins on stock index futures are too low and are inconsistent with cash market margins. As a result, market volatility is increased and market declines are exacerbated.
- Separate regulators can not effectively police intermarket frontrunning.
- The existence of two agencies in the United States to regulate securities and futures markets puts us at a disadvantage in international negotiations with the regulators from other major countries, all of whom have a unified system of regulation.
- The futures industry and the CFTC stifle innovation, most recently preventing index participation units (IPs) from trading in the United States.

Are these so-called problems real? Does the regulatory "wonder-cure," reducing the CFTC's jurisdiction by increasing that of the SEC, solve the problem? Are there any side effects

to this "wonder-cure?" Let's examine each of these claims and consider the facts. Facts, not assertions, are necessary to distinguish between true market reform and regulatory imperialism.

1. Stock index futures and related trading strategies have not driven the individual investor from the stock market.

The evidence is clear. Stock index futures are not driving the individual investor from the stock market. Direct stock market participation by individuals has indeed declined, but the decline began decades ago and is part of a transformation of the financial service industry around the world. In the 1960s and 1970s households shifted their asset holdings away from direct equity investments. For example, in 1968 households held 33 percent of their assets directly in stocks; by 1974 they held only 15 percent of their assets directly in stocks, and that fraction has been roughly constant for the last 15 years.[2] The retreat, then, occurred well before stock index futures and program trading appeared on the scene.

The trend away from direct individual investment has been accompanied by a long-term increase in equity holdings by pension funds and other institutional investors. The inevitable consequence of this shift from households to institutions is a

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[2]SEC memorandum, November 6, 1989. From Office of Economic Analysis, based on Federal Reserve Board, Flow of Funds Report.

shift in trading methods. Retail trading has declined dramatically just as block trading and other trading strategies have become more prevalent. The truth, then, is that the individual investor is still in the market, participating through institutions such as pension funds and mutual funds. And the risk associated with institutional positions in the stock market is frequently managed with futures contracts.

2. **Stock index futures trading does not increase stock market volatility.**

There is no credible evidence to support the contention that futures trading contributes to excessive volatility in the cash market. More volatile cash markets tend to have more active futures markets because cash market volatility increases the desirability of taking futures positions, not the other way around. The overwhelming consensus of many academic studies is that futures trading does not contribute to cash market volatility.[3] In fact, there is an emerging consensus that cash market volatility actually falls upon the introduction of futures.

3. **Raising stock index futures margins would not lower stock market volatility.**

Since margins serve fundamentally different purposes in the futures and securities markets, there is no reason why they

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[3]Clifford Smith and Charles Smithson, "Derivatives and Volatility," Intermarket, 1989.

should be set at the same levels. Futures margins are good faith deposits -- performance bonds -- set and required by exchanges and brokers to insure that buyers and sellers of futures contracts meet their respective financial obligations. Stock margins are not a performance bond but rather are a downpayment that limits the maximum credit that can be extended.

Less than two years ago, the Working Group on Financial Markets unanimously agreed that stock margins must be significantly higher than futures margins to provide the same level of financial protection.[4] The proof that the existing futures margining system works well is unequivocal. No futures clearing member firm defaulted in either October 1987 or October 1989.

In the face of such overwhelming success, the claim nevertheless has been made that futures margins, relative to stock margins, increase stock price volatility. Three assertions are advanced: (1) the high leverage due to low futures margins allows indirect, highly leveraged access to the stock market which leads to volatility; (2) the payments system is strained by demands for futures margin in times of extreme price fluctuations; and (3) margined futures traders are forced to sell to meet margin calls causing liquidity to vanish. Careful examination of each of these assertions has been unable to find supporting evidence.

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[4] Interim Report of The Working Group on Financial Markets, (Washington D.C.: Government Printing Office, 1988), 2.

(1) Leverage and volatility. Research conducted by economists at the SEC and the Federal Reserve Board, among others, finds no significant evidence of an inverse relationship between margins and volatility.[5] Direct research on margin policy in stock index futures is limited because stock index futures contracts only began trading in 1982. The two extant studies directly on the topic did not find that low margins lead to high volatility.

Nor does the evidence support the assertion that the stock index futures market is more highly leveraged than the stock market. Because of the different settlement periods, it is possible for there to be greater leverage for a player in the stock market than for one in the futures market. And, at times there is much greater opportunity for leverage in options on individual stocks than there is in the market for stock index futures. Moreover, the stock index futures market is used predominantly by institutions to hedge their cash market portfolios.[6] But a cash portfolio position hedged with a futures

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[5]See Dean Furbush and Annette Poulsen, "Harmonizing Margins: The Regulation of Margin Levels in Stock Index Futures Markets," Cornell Law Review 74 (July 1989): 873; and Paul Kupiec, 1989, Federal Reserve Board, Washington, D.C.

[6]According to a Stanford University economist, Jeffrey Williams, "[t]he salient feature of futures markets is precisely the frequency with which positions in futures contracts are combined with other positions." Jeffrey Williams, The Economic Function of Futures Markets (New York: Cambridge University Press, 1986), 41.

position is not leveraged, regardless of the level of futures margins.

(2) The strained payment system. In 1988, the Working Group found margins were set at prudential levels. The futures markets already meet or exceed the relevant recommendations to improve clearing and settlement systems made by the Group of Thirty for securities markets. Moreover, many improvements to the futures clearance and settlement systems suggested by the Working Group have been made already or are underway.

As long as settlements and payments continue to occur at different times for related positions there will continue to be systemic risk in the markets. The CFTC and the SEC have a good working relationship in these areas, having worked together on a number of measures.

(3) Selling to meet margin calls. This argument contends that traders are initially attracted by low futures margins and that adverse price movements prompt margin calls which force selling that would not otherwise have occurred. The argument suggests that futures traders must close their positions on volatile days to meet margin calls, prompting a decline in open interest for the futures contract as a whole and particularly for the affected group. An examination of the magnitude of open interest in the S&P 500 stock index futures contract on high volatility days contradicts the supposition that margin call sell-off exacerbated the market decline. On both October 19, 1987, and October 13, 1989, open interest at day's end was higher

than on the previous day--more positions were opened than were closed.

Furthermore, on October 13, only one of the 60 largest net position changes represented long liquidation by a speculator -- the speculator was a large commodity pool. Based on the fact the commodity pools typically hold a very large proportion of their total customer funds in short term interest bearing instruments, this sell-off was most likely responding to signals from a technical trading system, not to a variation margin call.

4. Separate regulators can effectively police intermarket frontrunning.

There is no concrete evidence that intermarket frontrunning -- that is, trading in one market while in possession of material non-public information about another market -- or any other intermarket trading abuse poses a significant threat to market integrity.

Within the securities industry, different stocks and option markets have developed intermarket surveillance techniques to detect frontrunning without requiring the merger of exchanges. Futures exchanges also have established inter-exchange surveillance procedures to actively monitor trading patterns for intermarket frontrunning. The enforcement divisions of the CFTC and SEC share information in a cooperative relationship and, indeed, have filed joint enforcement actions in other areas. We see no reason why this relationship will not continue regarding intermarket frontrunning and other intermarket abuses.

5. The existence of two agencies in the United States to regulate securities and futures markets does not put us at a disadvantage in international negotiations with the regulators from other countries.

To the world at large, the CFTC and the SEC are regarded as the leading regulators of futures and securities markets. Witness the times the CFTC has hosted delegations of foreign regulatory authorities who have a desire to learn how the most successful futures markets in the world are regulated, or the number of commodity futures statutes in effect in foreign countries which are patterned on the United States Commodity Exchange Act.

Our markets have prospered under the current regulatory structure. We see no reason to change our system to parallel systems of less experienced foreign authorities. In fact, while some other countries' regulators may appear in their organizational charts to have only one agency in charge of securities and futures products, in practice bilateral negotiation often means working with several bureaus or divisions within the same governmental organization.

Furthermore, there is no uniformity of regulatory structures among foreign regulators. A careful examination of the regulatory structure of different countries reveals a wide disparity of regulatory approaches across countries and a substantial degree of regulatory fragmentation within countries, particularly in those countries with the largest futures markets. For example:

- In Japan, three ministries, the Ministry of Finance, the Ministry of International Trade and Industry, and the Ministry of Agriculture, Forestry, and Fisheries administer three statutes which govern the Japanese securities and futures markets. Within the Ministry of Finance, two bureaus separately regulate financial futures and securities futures.

- In the United Kingdom, responsibility for regulating futures and securities business is vested in the Department of Trade and Industry, the Bank of England, the Securities and Investments Board, and specialized self-regulatory organizations such as the Association of Futures Brokers and Dealers and The Securities Association. Regulatory overlap is addressed by ensuring coordination and cooperation among regulators.

- In France, numerous laws govern futures and securities transactions and are administered by the French Ministry of Finance, the Commission des Operations de Bourse, an independent regulatory agency, and two legislatively created bodies, the Conseil de Marche a Terme (CMT) and the Counseil des Bourses de Valeurs (CBV). The CMT and CBV have primary responsibility for supervising the activities of, and transactions on, the futures and securities markets, respectively, and have unique rules and regulations

applicable to the markets which they regulate. The Bank of France also has relevant regulatory responsibilities.

To my knowledge, neither the SEC nor the CFTC has been impeded in its dealings with foreign regulatory authorities. On the contrary, both agencies have agreements with foreign jurisdictions encouraging information sharing and regulatory cooperation. In fact, the CFTC has led the way in developing financial and compliance information-sharing agreements.

It is hard to imagine how an SEC-dominated agency would be more effective at maintaining our competitive edge. Since 1975, United States equities have declined from about 63 percent to only about 29 percent of the world equity markets,[7] while the futures market still boasts a world market share of 70 percent.[8] It is interesting that the regulator whose industry has fared the worst internationally wants to take over the more successful industry in the name of international competitiveness.

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[7]Testimony of Louis Margolis, Managing Director, Salomon Brothers, before the CFTC Financial Markets Advisory Committee, November 1989.

[8]Chicago Board of Trade, 1989. "A Review of the Amount of U.S. Futures Business Left to Foreign Exchanges as a Result of Oversight Regulations in the United States."

6. The futures industry and the CFTC have not stifled innovation. In fact, the CFTC worked to accommodate IPs trading.

The most surprising argument now being made is that the CFTC and the futures industry stifle innovation. The CFTC's record on encouraging and accommodating innovation in financial products and trading systems is excellent. The United States futures industry has been the leading innovator of financial products, many of which it created within the past fifteen years. This impressive growth of new products and also whole new trading systems could not have occurred in an atmosphere that stifled creative thinking and frowned upon new ideas.

Since we are discussing the possibility of shifting jurisdiction to the SEC, it is appropriate to examine the record of support for innovation, particularly regarding derivative products, at the SEC. If the CFTC had not been a separate independent agency during the past 15 years, would we have seen the growth in products that has made the United States the financial futures and options center of the world? It is doubtful.

In 1975, the SEC threatened to go to court to prevent the Chicago Board of Trade from launching its GNMA futures contract. In 1978, the SEC unsuccessfully sought from Congress the CFTC's financial futures jurisdiction. In the early 1980s, the SEC opposed the introduction of stock index futures because it believed they served "no economic purpose." But by 1982 the SEC

was seeking jurisdiction over stock index options, and by 1988, jurisdiction over stock index futures.

Most recently, index participation products (IPs) have been called a market innovation that was stifled by the futures industry and the CFTC. Let us clear this up once and for all. An IP is not some novel form of security and certainly is not used for capital formation. Nor are IPs some form of innovative hybrid. IPs are simply futures contracts which by law must be approved by the CFTC in order to trade.[9]

You should also be aware of the effort the CFTC made to allow IPs to trade. Staff from the CFTC and SEC met on numerous occasions to try to resolve the regulatory issues. The CFTC offered to satisfy concerns raised by the securities industry and the SEC. For example, we proposed permitting securities account executives to be cross-registered as futures associated persons. In response to concerns about futures-style trading systems, the Commission offered to look at a market-maker system along with rules for large order execution of IPs. Unfortunately, the CFTC's overtures were rejected by the SEC.

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[9]As Chairman Breeden has himself acknowledged, issues of statutory interpretation are inherent in any statutory scheme. The definitions of securities and futures are intentionally broad in order to preserve flexibility to address fraud. Indeed, the issue of what constitutes a security has given rise to an enormous amount of litigation for nearly 50 years, far exceeding the relatively few cases concerning futures. Testimony before Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee, March 29, 1990, p. 21.

After the Court of Appeals ruled that IPs are futures, the CFTC contacted the Chairman, President, and Counsel for both the Philadelphia Stock Exchange and the AMEX, and offered to designate IPs on their futures exchange subsidiaries. Once again, the Commission offered to review cross-registration of Account Executives and Associated Persons along with proposed rules for different trading systems. Unfortunately, the securities exchanges chose to pursue their case in court; as a result, IPs, as they were proposed by U.S. securities exchanges, are not currently trading on any exchange.[10]

The litigation fostered by the IPs issue is not the way to deal with intergovernmental regulatory issues. A better model is to work to see if the desires of an exchange to trade a product, as well as the law and regulatory concerns, can be accommodated. In this regard, the Commission has not sought to impose its regulatory authority on any instrument with a bit of futurity. The CFTC has taken action to define its mandate in a pragmatic manner and has taken steps to clarify at which point a product must be regulated as a futures contract. Specifically, our

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[10]Recently, the Toronto Stock Exchange commenced trading on a different product, the Toronto 35 Index Participation Units (TIPs). The specification for these contracts as provided by the Ontario Securities Commission states that these contracts are units of a trust, the Toronto 35 Index Participation Fund created by the exchange. The Toronto Stock Exchange has informed us that it was very careful to structure these units to be deemed to be "securities" for Canadian tax purposes.

jurisdictional exclusion and exemptive rules concerning hybrid products as well as our swaps policy statement reflect this pragmatic approach.

Shifting Jurisdiction-- The Regulatory Costs

Costs to Market Users

Shifting the regulation of stock index futures to the SEC would be very disruptive to the most highly efficient and successful markets in the world. Market users who trade now with confidence and assurance in a familiar market system and under well-settled rules would face a transition period fraught with regulatory uncertainty. How would the SEC regulate these products? What rules would change, be added or be eliminated? This uncertainty will have accompanying costs, as market participants seek more stable trading environments to manage risk. The futures markets would become less liquid and efficient. Ultimately they could shrivel and be replaced by overseas markets which ironically would be perceived as more stable. What the United States does not need at this time is yielding any competitive edge to foreign markets.

Chairman Breeden has stated that stock index futures could be regulated as "securities." This would place futures in a hostile regulatory environment that could undermine the use of

futures as efficient hedging tools and could eliminate legitimate trading practices, like index arbitrage, that now exist. Most importantly, in the case of stock index futures, small regulatory changes would increase the costs of risk management and as a consequence the costs of using the securities market. Such regulation could, for example:

- hinder routine hedging activities: a portfolio manager hedging in futures who did not want to disclose his existing large cash market position in equities could be accused of trading on inside information and might therefore avoid trading in the futures market;

- impede liquidity: a long trader in Treasury Bond futures could not liquidate a losing position in a falling market if the "up-tick" rule applied;

- curtail trading activity: restrictions on the trading of stock index futures and related strategies could be imposed through "side-cars" and order entry collars;

- lose U.S. business: raising margin levels for futures would inevitably drive business to foreign exchanges whose margins for futures are currently comparable or lower than those in the United States;

- **increase regulatory burdens**: different disclosures may be required for different futures products, different trading rules may require reprogramming of systems and staffing changes;

- **increase transaction costs**: securities laws do not provide for segregation of customer funds but instead rely on SIPC insurance, which is funded through transaction fees;

- **cause duplicative regulation and registration**: state blue-sky laws could apply to contract designations and to market users, and certain firms might have to register as broker-dealers;

- **reduce customer remedies**: securities laws afford no reparations forum;

- **reduce enforcement authority**: SEC currently does not have power to impose cease and desist orders or civil monetary penalties.

These changes could increase, rather than decrease, stock market volatility while impairing if not crippling the hedging function of stock index and other financial futures. Restricting the use of futures, either directly or by limiting index arbitrage, will impair market liquidity, performance and efficiency. Raising false hopes about reducing volatility

through regulatory proposals that cannot accomplish the goal is bad public policy.

Costs to the Exchanges and Clearinghouses

Stock index, financial and agricultural futures contracts trade side by side on the floors of the same exchanges, by the same traders and under the same rules. All transactions are cleared and settled in the same way. Imposing dual agency regulation on the same exchange with two sets of rules governing the same trading floor and the same members engaged in the same activity would be highly inefficient if not an invitation to regulatory chaos. Two sets of rules for the same exchange clearing houses would also cause similar regulatory overlap or confusion. Moreover, a jurisdictional shift would not obviate--and in fact could increase--the need for continued coordination between the agencies that would exist. Some of the possible consequences of two regulatory systems as they would apply to exchanges and clearing houses are:

- <u>conflicting floor trading standards and recordkeeping requirements</u>: members of futures exchanges could be subject to different and likely conflicting floor trading standards and recordkeeping requirements for products regulated on the same floor by the CFTC and SEC;

- **duplicative and conflicting audits**: exchange compliance staffs could be subject to duplicative and potentially conflicting audits of exchange rule enforcement programs;

- **duplicative and burdensome compliance with rules**: futures exchanges could be burdened with having to file duplicative rules with the CFTC and SEC, account for differences in regulatory requirements in those submissions and coordinate approval and implementation;

- **coordinate emergency actions and review**: exchange emergency actions of general applicability would have to be coordinated with two regulators who both would review the actions;

- **different standards for trade and clearing records**: futures exchanges and their clearinghouses could be subject to two different standards governing the creation of trade and clearing records and exchange maintenance of those processes generally.

Costs to the CFTC

As you have stated, Mr. Chairman, overseeing futures trading involves more than "just planting a flag and bringing an occasional enforcement case." It requires the long-term,

dedicated effort of an experienced professional staff, which I am proud to say we have at the CFTC. Our team of economists, lawyers, accountants and futures trading specialists is as highly competent and motivated as any group with whom I have ever been associated. Like the industry that they help regulate, their expertise is highly specialized and cuts across all commodity groups. Splitting off stock index or financial futures from the CFTC's jurisdiction could result in a loss of experienced CFTC personnel, which would devastate agency morale and harm the effective oversight of the other futures markets that remain within our jurisdiction. And as with any championship team, there are certain players who are the franchise, who help to train the rookies and without whom the team loses its identity. That is certainly true at the CFTC where we are fortunate to have a critical mass of experienced personnel whose departure would decimate the agency.

It would be no easy task to replace these people. It is difficult enough to lure top personnel into Government service. This Committee is well aware of this problem since in S. 1729 it has authorized the Commission to establish a pay system comparable with other federal financial market regulators to help us recruit and retain personnel. Passage of this bill would be be an empty gesture, however, if we could not assure our candidates that the jurisdictional wars were over and there was not another hostile takeover in the wings.

What Price Merger?

It has been said that a merger will mean an end to agency disputes and can be accomplished leaving existing regulatory systems intact. But if futures are not to be regulated as securities and no other policy changes are intended, then what is to be gained by a merger? Moreover, even assuming no changes in regulatory policy, a merger poses other problems. For example, innovation that represented a competitive threat to existing securities products might not see the light of day. As Chairman Greenspan observed in discussing such dramatic changes as merger:

> these solutions [merger, shifting jurisdiction] would concentrate a great deal of regulatory authority over the financial system in a single agency and this has been a concern of Congress for a long time. In addition to the potential management difficulties of a larger organization, there is the risk that bureaucratic inertia in a larger agency could be an impediment to the process of innovation. We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures.[11]

Ironically, a single super agency may not mean regulatory peace in our time. Persons acting in good faith from either the same or different agencies can of course cooperate and coordinate regulatory programs. But a single agency does not guarantee this result. A super agency representing conflicting market interests

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[11]Statement by Chairman Alan Greenspan before the Securities Subcommittee of the Senate Banking, Housing and Urban Affairs Committee, March 29, 1990: 11.

will have a variety of divisions vying for power and authority. The contest for power may not vanish, but it could become intramural, paralyzing the decision-making process. Moreover, to the extent the disagreements are concealed from public view, they may become even more intense and divisive. And in any such struggles the cards would be stacked against the smaller CFTC. Furthermore, unless the law is significantly changed, third parties can still sue over specific product characterizations regardless of whether there are one or two agencies.

Merger would likely mean that the regulation of some futures products -- agricultural, energy and other physical commodities -- would suffer neglect at best. At the CFTC, futures are our most important product. This is true regardless of the commodity involved. We doubt this would hold true at a super agency whose budgetary and policy priorities would center upon regulating capital formation and the securities markets. Futures regulation of tangible commodities would likely become a regulatory stepchild in such an environment. Effective oversight and attention to futures trading could soon disappear if the CFTC were submerged in a super agency, most of whose personnel would know little about the highly specialized nature of futures contracts and the unique economic functions they perform.

In fact, one merger proposal already has relegated futures regulation of agricultural and other physical commodities to a

"division" within a new super agency. This is reminiscent of the days when the old Commodity Exchange Authority was a tiny component within USDA and regulated agricultural futures trading from the basement of the Chicago Board of Trade building (which often flooded!). But the public interest in properly functioning futures markets requires more than a return to the 1930s and a regulatory framework that Congress wisely abandoned. In creating the CFTC, this Committee recognized that the regulation of all commodity futures traded is important and will inevitably suffer if placed within a larger establishment with different, indeed conflicting, priorities and traditions. As the Committee reported in 1974 at the time it approved creation of an independent CFTC with exclusive jurisdiction to regulate futures trading in all commodities:

> [W]hile in the past the Commodity Exchange Authority of the USDA has been authorized to regulate only certain agricultural commodities that are produced in the United States, the Committee felt that agricultural products not produced in this country and commodities such as silver and copper, which have no relation to agriculture, could not be effectively regulated within the Department of Agriculture or an agency dominated by the Department of Agriculture. (S. Rep. No. 93-1131 at 21)

What argument would now lead us to believe that an agency mainly concerned with the cash securities market and with no relation to agriculture, silver, copper or energy products could effectively regulate futures contracts based on those underlying cash markets?

Conclusion

Throughout history vested interests have sought government help to thwart competitive threats fostered by innovation. That, I submit, is what is currently going on in the debate over stock index futures. It is no secret that traditional Wall Street brokerage and exchange interests are enjoying less than boom times. Making futures the fall guy may hamper or remove a competitive irritation for these traditional interests. But they will not address the problems that arose in October 1987 and October 1989. Nor will they contribute to the performance of our markets.

The case has not been made to disturb the existing jurisdictional assignment between the CFTC and the SEC. Any such change would have severe regulatory costs both for the markets and their customers. Congress should not tear apart a regulatory framework that has produced successful, competitive futures markets -- certainly not on the basis of unsubstantiated arguments. Quick fixes that do not address real problems will only create greater problems in the future.

Federal securities and futures laws have been and are flexible enough to accommodate change. To the extent that market innovation suggests further regulatory flexibility is needed, it can be accomplished within the current framework. A structural

overhaul is not required. The existing regulatory structure works and can continue to work if the agencies cooperate in good faith.

The CHAIRMAN. Chairman Greenspan, I appreciate your being here. I know that you testified on a similar subject before the Banking Committee and I appreciate your coming here to testify before us. It's all yours.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Mr. GREENSPAN. Thank you very much, Mr. Chairman, Senators. I will try to excerpt from my testimony, and I would suggest to my friend Rudy Boschwitz that he try to keep up with me. I will try to stay sequentially. [Laughter.]

The CHAIRMAN. Small words.

ISSUES INVOLVING THE REGULATION OF THE SECURITIES MARKETS

Mr. GREENSPAN. It is certainly a pleasure to appear before this panel today to discuss issues involving the regulation of the securities markets.

THE FEDERAL RESERVE BOARD DOES NOT BELIEVE THAT THE EXISTING DIVISION OF REGULATORY AUTHORITY HAS INCREASED VOLATILITY

The Federal Reserve Board does not believe that the existing division of regulatory authority has increased volatility in the securities markets, nor in this regard is it a threat to the capital formation process. Volatility in equity markets rather reflects economic fundamentals and changes in financial processes prompted by technological advances and the increasing concentration of assets in institutional portfolios. Efforts to restrain volatility by imposing more restrictions on particular markets or instruments could have unintended effects, resulting in significant costs on the system and a shifting of transactions activity offshore.

THE PRIMARY PURPOSE OF MARGINS

We continue to view the primary purpose of margins to be to protect the clearing organizations, brokers, and other intermediaries from credit losses that could jeopardize contract performance. As such, they are one important element of a package of prudential safeguards, including capital requirements, liquidity requirements, and operational controls, aimed at limiting the vulnerability of the financial markets to losses or disruptions arising from the failure of one or more key participants.

BOARD REMAINS SKEPTICAL, HOWEVER, OF WHETHER SETTING MARGINS ON STOCK-INDEX FUTURES AT LEVELS HIGHER THAN NECESSARY FOR PRUDENTIAL PURPOSES WILL REDUCE EXCESSIVE STOCK PRICE VOLATILITY

The Federal Reserve Board remains skeptical, however, of whether setting margins on stock-index futures at levels higher than necessary for prudential purposes will reduce excessive stock price volatility. Although available statistical evidence on the relationship between margins and stock price volatility is mixed, the preponderance of that evidence suggests that neither margins in

the cash markets nor in the futures markets have affected volatility in any measurable manner.

Thus, in the Board's view, the critical question is whether margins on stock-index futures have been maintained at levels that are adequate for prudential purposes. We have concerns about the tendency for these organizations to lower margins on stock-index futures to such a degree in periods of price stability that they feel compelled to raise them during periods of extraordinary price volatility. In the Board's view, somewhat higher margin levels on stock-index futures would obviate the need to raise them in a crisis and thereby reduce concern about the reliability of our market mechanisms, especially clearing and payment systems, in times of adversity.

BOARD BELIEVES THAT FEDERAL OVERSIGHT IS APPROPRIATE TO ENSURE THAT MARGINS ON STOCKS AND STOCK-INDEX FUTURES

The Federal Reserve Board believes that Federal oversight is appropriate to ensure that margins on stocks and stock-index futures are established at levels that are adequate under a wide range of market conditions. The appropriate Federal agency should have both the authority to initiate changes in margins on stock-index futures and the authority to veto changes proposed by the relevant SRO.

JURISDICTIONAL ISSUE

Either the CFTC or the SEC could play this role. On this jurisdictional issue, there are different views among Board members, but we agree that the Federal Reserve should not be given authority for futures margins and that our existing authority for stocks and stock options should be transferred to the SEC. The principal argument in favor of assigning oversight responsibility for stock-index futures to the CFTC is that it has overall responsibility for prudential supervision of futures exchanges and clearing organizations and futures commission merchants.

The principal argument for assigning oversight responsibility for stock-index futures margins to the SEC, a position for which I personally have a slight preference, is that it would foster consistency of margins in the stock and stock derivative markets. The Federal Reserve Board as a whole believes that margins in these markets should be consistent in the sense that they provide comparable protection against adverse price movements. The degree of protection provided by margin requirements depends on the magnitude of potential future price volatility. Although studies of past price movements can shed light on potential movements in the future, the forecasting of future volatility necessarily involves elements of judgment. Because different agencies are likely to come to different judgments, there is a case to be made for having only one regulator with margin authority over all the equity products markets to achieve consistency of margins across these markets.

This alternative would help achieve consistent prudential regulation across these tightly linked markets for equity instruments. However, such a measure would result in two regulators of futures exchanges and futures clearinghouses and hence would still require

a considerable amount of coordination on the part of the SEC and the CFTC.

One must recognize that stock-index futures are but one of many futures contracts offered by these organizations. Indeed, they are only one of many financial futures contracts. Should losses from stock-index futures trading—to be subject to SEC regulation under this alternative—jeopardize the financial integrity of a clearing organization or futures brokerage firm, it would threaten contract performance on all of the futures traded by the entity, including tangible commodity futures. Similarly, a failure in the commodity futures markets could, because of the effects on the clearing organizations or brokerage firm, have consequences for the equity markets.

Secretary Brady, in listing several various alternatives earlier this year, also has suggested much more far-reaching measures as possible ways to deal with the jurisdictional issue. For example, the transferring of all financial products to the SEC or the merging of the two agencies, although the current proposal obviously falls far short of that.

WE AT THE FEDERAL RESERVE BOARD WOULD URGE CAUTION IN CONSIDERING ANY OF THESE ALTERNATIVES

We at the Federal Reserve Board would urge caution in considering any of these alternatives. A full merger of the two agencies would avoid many of the problems just mentioned about overlapping jurisdiction in the regulation of exchanges and clearinghouses, and the transfer of all financial instruments to the SEC might be accompanied by the separate clearing of all financial futures subject to only one regulator. However, these solutions would concentrate a great deal of regulatory authority over the financial system in a single agency, and this has been a concern of Congress for a long time. We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Greenspan follows:]

For release on delivery
3 P.M. EDT
May 8, 1990

Testimony by

Alan Greenspan

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Agriculture, Nutrition, and Forestry

U. S. Senate

May 8, 1990

36-518 - 91 - 6

Mr. Chairman, members of the committee, it is a pleasure to appear on this panel today to discuss issues involving the regulation of securities markets. In particular, you have expressed interest in the adequacy of the existing regulatory structure with split jurisdiction over stocks and stock derivatives and the advantages and disadvantages of certain proposals for regulatory reform. I would like to focus my remarks on three major issues: first, the adequacy of margin requirements on stock index futures as a prudential safeguard and the impact of existing margin-setting procedures and other differences in regulation on market volatility; second, existing impediments to innovation; and third, whether there is a need to modify the existing regulatory system for stocks and stock derivatives. My evaluation will be done against the objective of a regulatory structure that, while limiting risks to the system, results in highly efficient and innovative U.S. financial markets that can compete effectively in the global marketplace.

As I will discuss in more detail, the Board does not believe that the existing division of regulatory authority has increased volatility in the securities markets, nor in this regard is it a threat to the capital formation process. We continue to view the primary purpose of margins to be to protect the clearing organizations, brokers, and other intermediaries from credit losses that could jeopardize contract performance. While we think that federal oversight of margins is appropriate for prudential purposes, there are different views among Board members on whether that authority is best vested in the Commodity

Futures Trading Commission (CFTC) or the Securities and Exchange Commission (SEC).

On the broader issue of consolidating jurisdiction for stocks and stock index futures (or all financial futures) in one agency, there are good arguments for and against such a consolidation and, accordingly, differences of views on whether such consolidation would, on balance, be beneficial. We believe some changes to the existing regulatory system are necessary to avoid the prospect that jurisdictional disputes among regulators will impede innovation in our financial markets, but consolidation of jurisdiction is not necessary to achieve this objective.

Federal Margin Regulation

A prominent area of disagreement among those interested in the smooth functioning of our capital markets has been the appropriate level of margins for stock index futures and the need for federal authority over such margins. In part, these disagreements reflect different views as to the purposes of margins and the appropriate objectives of federal margin regulation. Accordingly, at the outset I would like to clarify the position of the Board of Governors on these issues.

We continue to believe that the primary objective of federal margin regulation should be to protect the financial integrity of market participants and thereby ensure contract performance. Margins should be adequate to protect clearing organizations, brokers, and other lenders from credit losses arising from changes in securities prices. As such, they are one important element of a package of prudential safeguards, including capital requirements, liquidity requirements, and operational

controls, aimed at limiting the vulnerability of the financial markets to losses or disruptions arising from the failure of one or more key participants. The failure of, or even the loss of public confidence in, a major intermediary in any of the stock, futures, or options markets could immediately place significant strains on other markets, their clearing systems, and on our nation's payment system.

The Board remains skeptical, however, of whether setting margins on stock index futures at levels higher than necessary for prudential purposes will reduce excessive stock price volatility. We, too, are concerned about what seems to be a higher frequency of large price movements in the equity markets, but we are not convinced that such movements can be attributed to the introduction of stock index futures and the opportunities they offer for greater leverage. Although available statistical evidence on the relationship between margins and stock price volatility is mixed, the preponderance of that evidence suggests that neither margins in the cash markets nor in the futures markets have affected volatility in any measurable manner. Moreover, we are concerned that raising maintenance margins on stock index futures to levels well above those necessary for prudential purposes could substantially reduce futures market liquidity or drive business offshore.

Thus, in the Board's view, the critical question is whether margins on stock index futures have been maintained at levels that are adequate for prudential purposes. Although no futures clearing house has ever suffered a loss from a default on a stock index futures contract, certain actions by futures exchanges and their clearing houses

in recent years raise questions about the adequacy of futures margins from a public policy perspective. Specifically, we have concerns about the tendency for these organizations to lower margins on stock index futures to such a degree in periods of price stability that they feel compelled to raise them during periods of extraordinary price volatility. While such a practice has heretofore protected the financial interests of the clearing houses and their members, it tends to compound already substantial liquidity pressures on their customers, on lenders to their customers, and on other payment and clearing systems. In the Board's view, somewhat higher margin levels on stock index futures would obviate the need to raise them in a crisis and thereby reduce concerns about the reliability of our market mechanisms, especially clearing and payment systems, in times of adversity.

The Board believes that federal oversight is appropriate to ensure that margins on stocks and stock index futures are established at levels that are adequate under a wide range of market conditions. Futures self-regulatory organizations (SROs) should continue to have primary responsibility for developing and refining margin policies. But the appropriate federal agency should have both the authority to initiate changes in margins on stock index futures and the authority to veto changes proposed by the relevant SRO. That authority should not be limited to emergency authority such as the CFTC currently has over futures margins.

Either the CFTC or the SEC could play this role. The principal argument in favor of assigning oversight responsibility for stock index futures to the CFTC is that it has overall responsibility for prudential

supervision of futures exchanges and clearing organizations and futures commission merchants (FCMs). Assignment of oversight responsibility to the CFTC would avoid certain regulatory burdens and potential conflicts that could arise if responsibility for critical aspects of prudential oversight of such entities were divided between the CFTC and SEC.

The principal argument for assigning oversight responsibility for stock index futures margins to the SEC is that it would foster consistency of margins in the stock and stock derivative markets. The Board believes that margins in these markets should be consistent in the sense that they provide comparable protection against adverse price movements. The degree of protection provided by margin requirements depends on the magnitude of potential future price volatility. Although studies of past price movements can shed light on potential movements in the future, the forecasting of future volatility necessarily involves elements of judgment. Because different agencies are likely to come to different judgments, there is a case to be made for having only one regulator with margin authority over all the equity products markets to achieve consistency of margins across these markets.

On balance, the Board does not see a clear basis for choosing between CFTC and SEC oversight of stock index futures margins. The Board feels strongly, however, that authority should not be given to the Federal Reserve because it does not have overall prudential responsibility for any of the futures commission merchants (FCMs), broker/dealers, or clearing organizations that margins are intended to protect. The existing margin authority for stock and stock options

assigned to the Board under the Securities Exchange Act of 1934 should be transferred to the SROs and the SEC.

Issues of Regulatory Jurisdiction

The question of regulatory responsibility for margins is one element of the broader question of regulatory jurisdiction over futures and options markets. In light of the strong linkages among the markets for futures, options, and their underlying instruments, some have argued that the division of oversight responsibilities among agencies may impede the effective regulation and supervision that is essential to ensure sound and efficient financial markets.

One particular concern relates to volatility. It is frequently argued that leveraged trading in stock-index futures and options, encouraged by low margin requirements on derivative products, has led to increased volatility in the prices of the underlying stocks. More generally, it has been suggested that other inconsistencies in market mechanisms involving, for example, circuit breakers and short-selling rules, contribute to market instability. It is feared that increased price volatility, in turn, will reduce the attractiveness of equity markets and could impede the capital formation process. These concerns have prompted calls for one regulator who will take steps to remove inconsistencies that may contribute to sharp price swings.

The Board does not share the view that split regulatory authority over equity instruments has in any meaningful way contributed to volatility. As I noted earlier, we have found no substantial evidence linking margin levels to price volatility in the cash or the index-product markets. Nor have studies revealed a clear understanding

of how circuit breakers and other market rules affect price movements in the different markets.

In a more fundamental sense, we believe that it is counterproductive to lay blame on one sector, in this case the market for stock index derivatives, for the increasing occurrence of wide and rapid price swings in equity markets. Rather, the volatility we observe reflects more basic changes in economic and financial processes prompted by technological advances and the increasing concentration of assets in institutional portfolios. The delegation by the public of the management of a large proportion of its assets to professional managers through pension funds and other institutions and the desire of these managers for low-cost methods to manage risk and adjust portfolios has spurred growth in the new instruments; improvements in telecommunications and computer technology mean that information on economic fundamentals will be received and translated by these managers more quickly into market prices. To the extent that price movements reflect these basic forces, efforts to restrain volatility by imposing more restrictions on particular markets or instruments could have unintended effects, resulting in significant costs on the system and a shifting of transactions activity offshore.

A second issue frequently raised in evaluating the adequacy of our current regulatory system concerns product innovation. Many of the new products being developed on futures and options markets are not easy to classify. They have important similarities to, or are otherwise linked to, a variety of existing instruments subject to different regulators; and, as a consequence, various uncertainties and frictions

have emerged about the appropriate exchanges that should trade these instruments and the agencies that should provide regulatory oversight. One recent example involves the "index-participation" or IP contracts that were introduced by several of the stock exchanges, approved by the SEC for securities trading and, in essence, disapproved when the courts ruled that IPs were futures products subject to the exclusive jurisdiction of the CFTC and could not be traded off of exchanges regulated by the CFTC.

Under the Commodities Exchange Act (CEA), any commodity contract with an element of futurity cannot be entered into except on a CFTC-regulated exchange. Moreover, this act defines the term "commodity" very broadly to include not only physical commodities, like corn and wheat, but intangible contractual interests, including financial instruments. This restriction, when interpreted broadly, serves to discourage the development of new financial products that might be offered outside of the futures exchanges and tends to stifle the innovation process. In a very general sense, all financial instruments have an element of futurity in them, in that their value depends on future events. We believe the CEA can be modified in ways that preserve the public safeguards that motivated this provision, while preventing conflicts in this area from having to be dealt with by the courts and without impeding the process of innovation in equity and other instruments. Such modifications might include an exemption for transactions subject to other regulatory safeguards, sophisticated trader exemptions, or more stringent fraud liability.

Alternative Regulatory Structures

As I have noted, a case can be made for having only one federal agency with oversight authority over margins in the equity and equity derivative markets. This case rests not on the issue of volatility but on the fact that setting prudential margins requires judgments concerning potential future price volatility in the linked markets for stocks and derivative products. One regulator would provide a single view of potential future volatility in these markets and thereby foster consistency of margins across the various segments of the equity markets. Others would go further and transfer all regulatory authority over stock index futures and options on such futures to the SEC. This is one of the possibilities recently identified by Treasury Secretary Brady.

This alternative would help achieve consistent prudential regulation across these tightly linked markets for equity instruments. However, such a measure would result in two regulators of futures exchanges and futures clearing houses, and hence would still require a considerable amount of coordination on the part of the SEC and CFTC. One must recognize that stock index futures are but one of many futures contracts offered by these organizations--indeed, only one of many financial futures contracts. Should losses from stock index futures trading--to be subject to SEC regulation under this alternative--jeopardize the financial integrity of a clearing organization or futures brokerage firm (FCM), it would threaten contract performance on all of the futures traded by the entity, including tangible commodity futures. Similarly, a failure in the commodity futures markets could, because of

the effects on the clearing organization or brokerage firm, have consequences for the equity markets. In another area, many exchange rules related to trading and clearing cut across a wide range of contracts rather than being specific to stock index contracts, and close coordination between the SEC and CFTC would be important in evaluating such rules.

Thus, the SEC would have an important interest in other aspects of futures market regulation while the CFTC would continue to have a strong interest in the regulation of stock index futures. The logic of transferring stock index futures to the SEC because of their tight linkage to the cash market suggests that futures contracts on other instruments also might be regulated differently. That is, Treasury futures would be regulated by the Treasury and Eurodollar and foreign currency futures by the Federal Reserve. Such a change, however, would increase the regulatory fragmentation in the securities markets and would not appear to be a particularly useful realignment. Consequently, the benefits of transferring regulatory jurisdiction to the SEC for purposes of achieving more consistency of regulation across equity instruments must be balanced against these drawbacks, and there is scope for legitimate differences of view on whether such a measure would be a net improvement.

Secretary Brady also has suggested much more far-reaching measures to deal with the jurisdictional issue--the transferring of all financial products to the SEC or the merging of the two agencies. We would urge caution in considering these alternatives. A full merger of the two agencies would avoid many of the problems just mentioned about

overlapping jurisdiction in the regulation of exchanges and clearing houses, and the transfer of all financial instruments to the SEC might be accompanied by the separate clearing of all financial futures subject to only one regulator. However, these solutions would concentrate a great deal of regulatory authority over the financial system in a single agency and this has been a concern of Congress for a long time. In addition to the potential management difficulties of a larger organization, there is the risk that bureaucratic inertia in a larger agency could be an impediment to the process of innovation. We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures.

The CHAIRMAN. There is a vote on. I am going to do as suggested. We will recess for 10 minutes and then come back and immediately start questions. If there is going to be more than one vote, I will still come back in between and try to get the questions started.

We stand in recess for 10 minutes.

[Recess.]

The CHAIRMAN. I will start in, and members will be coming back as they can.

Now, first off, I should note that I appreciate the testimony of everybody here today. I know that each of you has spent a great deal of time in it. So let me just go back and have you refer to some of the testimony and see where we go from there.

Secretary Glauber and Chairman Breeden, in your testimony, if I could summarize a little bit—and feel free when I am finished to correct anything you don't think is correct in my summary—you propose to strip the CFTC of jurisdiction over stock-index futures contracts and transfer that duty over to the SEC.

Now such an idea raises two key questions in my mind. The first would be: Could the SEC handle this new responsibility any better than the CFTC does today? And second, would such a move cripple the CFTC in carrying out its remaining duties?

I mention these two points because they will be in the front of my mind as I also ask questions of Chairman Gramm and Chairman Greenspan. As you know, this committee has been determined to clean up the Chicago exchange floors from trading abuses, a problem that affects stock-index futures as much as any other commodity. I might say that the vast majority of those involved in trading want us to clean up such abuses.

Mr. Breeden, you have argued that SEC control of stock-index futures could help prevent another stock market crash as we saw in 1987 and 1989. As we look at this issue, we have to know what your plans are if Congress were to give the SEC the power tomorrow how you would propose to accomplish the goals of preventing trading abuses while eliminating volatility in the stock market.

Let me go to just a few specifics. If stock-index futures were regulated by the SEC—and I will direct this, Mr. Breeden, to you—would you allow these contracts to continue to trade under the open-outcry system or would you force them to trade through exchange specialists or under a multiple market-maker system like stock options on the CBOE?

Mr. BREEDEN. Senator, there are a variety of ways in which one could alter both the legal status and trading practices if a change were made. One could treat stock-index futures as securities and try to have them conform to the system in the securities world, or one could continue to treat them as futures and continue to apply the Commodity Exchange Act and start off with the existing rules and regulations of the CFTC that apply to those markets.

I tend to favor the latter approach. I think that the logical and natural starting point is to simply provide that the existing law would be administered, in the case of equity derivatives, by the SEC, and, in the case of agricultural commodities and financial futures other than equity derivatives, by the CFTC.

The CHAIRMAN. Does that mean that if stock-index futures were regulated by SEC, you would have them trade under the open-outcry system?

Mr. BREEDEN. Yes.

The CHAIRMAN. Would you ban dual trading in the futures pits where a broker executes customer orders and also makes personal trades, or would you limit the dual trading to small, inactive pits or to trading floors where the exchange is able to police the practice against abuses?

Mr. BREEDEN. I don't know how long the list of items that we want to run through is, but just as an overview that would be a caveat to my answer to any of these types of questions as to how we would do something—that very much depends on the mandate that we would be given by Congress. It is Congress that would establish the rules. It would decide, for example, whether the existing trading system under the CEA should be continued or whether something else should be developed.

We would be perfectly comfortable in taking as a starting point the existing statutory requirements that have been laid down by the Congress and by this committee. To the degree that there need to be changes, the first thing we would want to do would be to solicit a wide spectrum of public comment to the extent it was a rulemaking question where we had discretion. We would solicit the views of the industry and others on how a given question should be addressed in exactly the same way that we consider the public's views before we act on proposals under the securities laws.

So I can't just sit here and say here's how I would do all these things. It would depend on rulemaking and notice and comment.

The CHAIRMAN. We are making changes in this area in the futures trading practices legislation that is now before the Senate and that has been passed unanimously out of this committee. Obviously if futures trading is turned over to the SEC, this would have to be a major trading practice concern.

What would you favor, you personally?

Mr. BREEDEN. I would favor eliminating dual trading. We do not utilize dual trading among floor brokers generally in the securities markets.

The CHAIRMAN. Can't New York Stock Exchange specialists dual trade within certain limits?

Mr. BREEDEN. There are in certain cases procedures under which specialists and others who have very carefully defined duties and limits can engage in dual trading practices. But, in terms of the general approach, I would favor restriction of that practice.

The CHAIRMAN. Well, you know that there are certain restrictions in our bill and the CBOE rules ban same-day dual trading on stock options, for example.

Mr. BREEDEN. Right.

The CHAIRMAN. Would you impose a so-called uptick rule on stock-index futures to ban short sales when the prices have fallen?

Mr. BREEDEN. Well, there again it would depend on what the law was that we were operating under, and I can't hypothetically answer what we would do. We would apply the law that Congress gives us. That's the way we operate and are required to operate. We have interpretations under existing securities laws, and, if the

question is would we try to apply every single interpretation of the Securities Act of 1933 or the Securities Exchange Act of 1934 in crafting rules under the Commodity Exchange Act, assuming that is what Congress asked us to administer, the answer is: certainly not.

The CHAIRMAN. Mr. Glauber, how do you feel about this? I think you talked about the evasion of the stock short-sale rule as being a problem, if I recall your testimony. So what would you recommend on that?

Mr. GLAUBER. I think what I would do is point to the fact that this is one of those intermarket inconsistencies. There are good reasons why the futures market has not had an uptick rule. Futures markets are different from stock markets in some very real senses.

The problem we wanted to point out was the linkage between these two markets together with the set of rules in one market and the set of rules in the other that leads to an inconsistency, and we would suggest that what is needed is one regulator to look at both of those, and we would defer to the regulator in that judgment.

The CHAIRMAN. Let me ask about another area. The futures reform bill from this committee allows customers to collect punitive damages in civil lawsuits against floor traders in futures markets. It also holds retail brokerage firms liable for actions of independent floor brokers.

Mr. Breeden, would you apply that rule to stock-index futures trading as well as to other commodities?

Mr. BREEDEN. Again, Mr. Chairman, I would say that is a question of the statutory standards that would be applicable. A system like that would not be created by rule, either ours or the CFTC's, but rather by statute. As I said, our preference would be to continue to treat stock-index futures as futures under the Commodity Exchange Act. The systems that apply under that act to other types of futures would continue to apply to stock-index futures, including the reparations system and the mechanisms you suggest.

The CHAIRMAN. Let me ask you about that. We do allow the punitive damages, as I said. Would you recommend that they be extended to the stock market? Admittedly we can do it legislatively. I am just curious as to what your recommendation is because the securities laws don't provide for punitive civil liability except under RICO. I think we have put together in our futures reform bill a much tougher law than the securities law.

Should we apply this provision to the stock market too if we are all going to be good and tough here? Should we apply the same thing to the stock market that we have applied to the futures market?

Mr. BREEDEN. Well, we would like to start with passage of the Securities Law Enforcement Remedies Act, which is pending before the Congress right now, and which we think is very important. If it's enacted, I would certainly be happy to take a look at how the system you are describing works in the futures market and to consider its applicability to securities. But I don't ever like to make recommendations for legislative action without carefully studying the merits of the issue.

The CHAIRMAN. Secretary Glauber, do you want to walk into that minefield? [Laughter.]

Mr. GLAUBER. I think I would not. It is a regulatory issue that really is beyond what I think I am competent to comment on.

The CHAIRMAN. I ask these questions because if we are to follow what you have recommended, Secretary Glauber, on behalf of yourself and Secretary Brady and backed by Chairman Breeden, then you are asking for major changes. I am trying to anticipate the kinds of questions that will come up on the floor when this comes up.

We know how the futures market works under CFTC; we know what it is under our bill. If it is voted to send stock-index futures over to the SEC, then we are really sending it out into an uncharted area; we don't know what is going to happen.

Let me ask you this: Would you allow customers who are defrauded in the stock-index futures markets to continue to bring cases under a reparations system, or would they have to press their claims before an industry-run arbitration panel? Which would you prefer, Secretary Glauber?

Mr. GLAUBER. As I said in my testimony, what we would prefer is to effect this change in the least disruptive way; that is, to do it in a way that preserved the existing practices in the futures markets. And I think that that is very important to try to accomplish.

The CHAIRMAN. That would be a reparations system?

Mr. GLAUBER. Again, I don't feel that I am in a position to comment on specific regulatory issues. As a general matter of policy, what I would like to say is that I think the philosophy underlying our recommendation is that the economic reality, the way markets work, ought to dictate the way they are regulated. These markets work as one market, and we think that they should have one regulator but that it should be done in the least disruptive way possible.

The CHAIRMAN. Chairman Breeden, reparations or arbitration panels?

Mr. BREEDEN. Again—and I am speaking only personally since I have not had a chance to ask this of my colleagues at the Commission—but I personally would favor continuing the reparations system. Indeed, I would think that it would be perfectly possible to continue the current administration of that system as it is at the CFTC, with appeals from the decisions rendered by that process being simply taken to the SEC rather than the CFTC. I think that would be smooth and efficient and wouldn't be in the least disruptive to market participants.

The CHAIRMAN. I want to make sure that I understand this. If something came before an administrative law judge at the CFTC, would it be appealed to the SEC?

Mr. BREEDEN. Sure. Simply process the case under the existing system and take the appeal to the SEC. Not really much different from taking an appeal to one Court of Appeals versus another.

The CHAIRMAN. Would you have to add new administrative law judges to hear these cases?

Mr. BREEDEN. No. I think the best thing would be to use the ones who are in place already. But we could do that.

The CHAIRMAN. You would regulate and oversee it, but the reparations case would be heard before a CFTC administrative law

judge and the appeal would then go back to the SEC? Am I following you correctly?

Mr. BREEDEN. Well, that is certainly one way to do it and, I would think, an easy way to do it. We, of course, have administrative law judges as well. We could use an SEC administrative law judge. They are not supposed to be representing the agency, but rather acting as a judge. I think we could use as a finder of fact an ALJ employed by the SEC or the CFTC. In either case, you then take an appeal on that matter exactly as we now take appeals, but to the SEC if that agency has jurisdiction over the product. That is a very simple process.

The CHAIRMAN. My time is up, but I wanted to know whether Dr. Gramm or Chairman Greenspan wanted to add anything to that. Then I will yield to Senator Lugar.

Dr. GRAMM. Well, I guess I am somewhat puzzled about how such a process would work. It might be awfully confusing for the ALJ's and the CFTC staff who work on reparations to be reporting to, I guess, the SEC.

Obviously I do have some concerns about how such a proposal would be implemented. I also would have concerns about all the ongoing rulemakings that would cover not only stock-index futures but all the other contracts as well, not only dual trading but the trading card rule, disciplinary committee rules, all of the rulemakings that are in process now, to what extent would they be halted and thereby changed if there were a shift in jurisdiction.

We have a number of programs at the CFTC for monitoring the pits directly, for example. I think it could be very confusing if the SEC had a different set of rules, a different set of dual trading or trading card rules for those who are using the markets.

I believe at this point in time the SEC does not directly monitor the floor trading practices of the securities exchanges, and so that is something that would have to be changed for effective monitoring of futures-style trading.

There is a whole host of questions that this proposal raises that I have not had a chance to really think through, but it sounds very, very confusing, more confusing, perhaps, than just shifting stock-index futures jurisdiction over to the SEC directly. But the joint SEC-CFTC implementation of the Commodity Exchange Act, especially if you eliminate the exclusive jurisdiction, could result in a tremendously confusing prospect for people who are on the floors of those exchanges and, therefore, for the users as well ultimately.

The CHAIRMAN. Chairman Greenspan, do you want to jump into this donnybrook?

Mr. GREENSPAN. I would suspect I would have nothing useful to add. [Laughter.]

The CHAIRMAN. I rather suspect you could, but I suspect you are not going to at this point. [Laughter.]

The CHAIRMAN. It is wisdom in that regard.

Senator Lugar.

Senator LUGAR. Well, thank you, Mr. Chairman.

As has been related already, this committee entered into the reauthorization of CFTC at a time of considerable difficulty in the commodities markets. In that environment we produced a bill that has great strength and merit, and I suspect we will be able to come

to conference with the House and bring at least confidence in terms of our role.

I do not by any means diminish the importance of the amendment offered by my distinguished colleague from Washington, who has raised an issue of jurisdiction. And clearly, either our colleague anticipated interest by the administration in this regard or the administration signaled interest and indeed has followed through on it.

But in any event, we have a situation, as I see it, Mr. Chairman, in which we really need to bring this bill to the floor of the Senate; I hope, as you suggest, with a tight time agreement. I think the Senator should have an opportunity to offer his amendment, and it will either rise or fall on its merits.

What I see coming is a very broad-gauge study of jurisdiction and equities that surpasses almost all the testimony we had last year on the entire issue. And I admire the ability of Alan Greenspan always, but especially here to try to sift through the data and find out that there is not a great deal in these arguments. His position comes down, I think, slightly with a disposition on one of the four major charges for reform, but stripping away all of this, it seems to me that there is a question perhaps that this committee might have taken a look at more carefully in terms of the prudential factor of margins and to make certain that there is consistency in margins. I think that that message comes through, at least in terms of my own sympathies with this testimony today.

With regard to the volatility issue, every academic study that is flooding in to us show little correlation. You can make a case for change any way you want to. Now, what I hear loud and clear—and what I don't want to hear—is the administration essentially saying, we have had four large disruptions in the stock market in the last 2 years or so and somehow that is due to the fact we haven't fixed this particular problem. And therefore if you don't adopt our idea, heaven help you if we have a fifth disruption because we will sort of lay that on your doorstep and hold you responsible.

Now, that is irresponsible logic when you have one academic study after another showing very, very little correlation in terms of the volatility argument. And I would suggest that far from there being absolutely no apparent reason for the stock market falling from time to time, there appear to me to be a whole lot of rational economic reasons in the world for a stock market reaction.

One can always ask why a reaction occurs on one day as opposed to another. One could ask why the Japanese stock market didn't fall before this year even though most everyone felt there were large dislocations there that are only now being reflected. And some could even say the Japanese market is the fault, the consequence of their taking trading instruments from the United States over to Japan, foisting that difficulty upon themselves.

So, Mr. Chairman, I hope that we can move forward on this issue. I think there is probably merit in taking up each of the items that has been discussed today. And it may be that an independent package of reform will come of it. But I must say I don't see very much at this stage.

Now, I would like to ask Mr. Greenspan, since I have cited his testimony, in trying to get to the prudential standard with regard to margins.

Playing the ball from where we are now, is this an issue or a power that should be taken from the exchanges and given to the CFTC, or since you've said that you don't want it at the Fed to the SEC?

Mr. GREENSPAN. Senator, on the question of margins, the issue really breaks down into an insoluble problem, which is essentially that you can either look at margin coordination on the basis of the particular exchange with which you are dealing so that one regulator sets the margins for all the products that are traded on a specific exchange.

That obviously has certain advantages because it enables the regulator to go across products with individual members and to get what that regulator would presume to be prudential margins from the point of view of the exchange as such.

The alternative, and in a sense the mutually exclusive procedure, is to try to present margin calculations on the basis of products which are determined by the same set of pricemaking forces. The only way in which you can avoid the problem is to have essentially only certain types of products on a certain exchange or only one product per exchange.

In this particular instance, and I have looked at this in some detail, I and my fellow Board Members have taken several different positions on this, and we don't agree.

I personally think that because the pricemaking mechanism is the more important of the two by a small margin, I would tend to be favorably disposed toward putting the index futures and the stocks under the same regulator so that we do not have divergent views about the future price movements in these markets being reflected in different evaluations and hence presumably different prudential margins for index futures on the one hand and stocks on the other. In other words, I would like to see them reflect the same pricemaking forces.

Senator LUGAR. Is there any way to get to that point, aside from curing the margin situation? It is your recommendation to meld all of these instruments together under one jurisdiction?

Mr. GREENSPAN. Well, no. I find that the administration's proposal that Under Secretary Glauber brought forth this afternoon does actually implement the view that I personally hold. There are other ways, obviously, of doing that.

The one thing I would strongly suggest would, as I indicate in my testimony, is that one avoid endeavoring to merge these two organizations, for I fear that that would not be useful in maintaining the optimum regulatory system in this country.

Senator LUGAR. I thank you.

That is my only question, Mr. Chairman.

The CHAIRMAN. Thank you.

I might say, incidentally, that Senator Lugar is absolutely right in his comments. Let us not blame the ills of the world on the immediate progress of this particular piece of legislation.

I would be happy to join with the distinguished Senator from Indiana in sending a letter to the two leaders of the Senate urging,

one, that the bill come up on the floor and, two, that it come on the floor under a relatively tight time agreement. The major issues in the bill itself were debated at some length and were passed with a great degree of unanimity. I don't think that those are the parts that would take much time. But I would work with the Senator from Indiana to see if we can possibly get something like this on the floor. I would love to see it come up under no more than a 2-day time agreement so we can vote these issues up or down.

This is all the more reason, I might say why your answers to the questions of mine are important, Chairman Breeden and Secretary Glauber. These are not just questions I am asking for academic interest. I have anticipated that this matter will be on the floor, Chairman Gramm and Chairman Greenspan, and a lot of questions will be raised by different Senators. I want to have a clear enough record so that we will be able to respond to them.

That is why I will also have extensive questions for the record which I will submit and that I will want you to look at very carefully. They will be part of that debate.

Next on the list, we have Senators Gorton, Kerrey, Bond, and Boschwitz to ask questions.

Senator Gorton.

Senator GORTON. Chairman Greenspan, you just answered the question which I was going to put to you, and while perhaps without quite the degree of enthusiasm that I do, we are in accord on both halves of that answer: this consolidation, but not a merger of the two agencies.

Perhaps an appropriate followup to that, on the part of this Senator, is simply to say that this, from my point of view, is an institutional problem and not a criticism of the Chairmanship of Mrs. Gramm of the CFTC, whose reappointment I support very enthusiastically. And I just wondered whether or not you would favor the committee with whether or not you feel that she ought to be reconfirmed as Chairman of the CFTC?

Mr. GREENSPAN. Most certainly. I think she has been a very effective Chairman and has been extraordinarily easy to work with within the Working Group on problems that we have had. So I certainly would hope that the Senate would move expeditiously on this issue.

Senator GORTON. Thank you very much.

My next question is to Secretary Glauber and really is a followup on that: Is this problem, from your perspective, Mr. Secretary, a failure of the CFTC to do its job, or simply is it endemic in the current regulatory structure and the division of the regulation of the subject matter of this debate?

Mr. GLAUBER. No. I think the problem is we are asking regulators to perform an act which is very, very difficult, and that is to have two regulators try to regulate what is one market. It is a problem of regulatory structure, not of agencies and certainly not of people.

Senator GORTON. CFTC, as I understand it, Mr. Secretary, was originally established to regulate commodity futures, and it in the course of the last 8 years that the jurisdiction over stock-index futures has been added.

Do you feel on the one hand that the CFTC, by reason of this addition, has gotten away from its original mission to a certain extent? What would be the significance or is the significance of CFTC regulation of stock-index futures to the agricultural community?

Mr. GLAUBER. Well, as I said in my testimony, I think they are obviously not closely related at all. I think the significance has been that this debate has distracted them perhaps from their traditional regulatory responsibility. I think that if this were cleared up, they could turn their attention back to those issues.

If I might just return to something that Chairman Greenspan said, I think I view it in very much the same way; that is, the issue of where stock-index futures should be regulated. They are on the one hand a future, and on the other hand they are very, very close to being like stocks. And it is a judgment that one has to make: Do you push them one way or the other?

The decision was made 8 years ago to push them one way, toward futures. I think we would likely draw the line on the other side today if we were doing it again, knowing what we know now. And indeed faced with the information that they now have, other countries, when they designed their regulatory structures, have chosen to push stock-index futures toward the regulator that does stocks.

Senator GORTON. Mr. Chairman, could I interrupt at this point? Have you included in the record your letter to the Secretary of the Treasury of March 20, 1990, and his response, which is dated today? Can both of those be included in the record?

The CHAIRMAN. If they are not already in the record, they will be at this point.

[The correspondence referred to follows:]

UNITED STATES SENATE,
COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,
Washington, DC, March 20, 1990.

The Honorable NICHOLAS F. BRADY,
Secretary of the Treasury, 15th and Pennsylvania Avenue, NW., Washington, DC 20220.

DEAR MR. SECRETARY: As you know, events in 1989, particularly the indictments of 48 Chicago floor traders on charges of defrauding customers, demonstrated the need for significant reform of trading practices in the commodity futures markets. In November 1989, the Senate Committee on Agriculture, Nutrition, and Forestry responded by reporting the toughest futures reform package in decades. That legislation, the "Futures Trading Practices Act of 1989" (S. 1729), substantially beefs up the resources and legal powers of the Commodity Futures Trading Commission, increases penalties against wrong-doers and legal remedies for victimized customers, sets strong conflict-of-interest rules for exchanges, requires exchanges to implement state-of-the-art audit trail systems, curbs dual trading if not strictly policed, mandates industry service fees, and takes other needed steps.

Unfortunately, movement of S. 1729 to the Senate floor has become tangled in recent debate over the respective jurisdictions of the CFTC and the Securities and Exchange Commission for certain financial-based instruments. That debate is important, but it should not be a basis to block essential trading practice reforms. These reforms affect *all* futures markets—agricultural, petroleum, metals, and currencies as well as stock-index and interest-rate products. The need for these reforms is well documented by Senate committee hearings and General Accounting Office reports; they are widely supported by market users, producers, law enforcement officials, and regulators.

Unless consideration of S. 1729 is separated from the debate over SEC/CFTC jurisdiction, we face the prospect of futures trading reforms being delayed indefinitely.

In your letter to Senator Christopher Dodd of March 2, 1990, you acknowledged that internal administration talks on SEC/CFTC jurisdiction were far from settled: "It is not clear how quickly it [the Working Group on Financial Markets] will conclude its deliberations or whether, once it does, it will reach any broad-based consensus." Congressional debate over these proposals is likely to be divisive. A resolution in the current crowded congressional session is far from assured.

In a similar situation, you have signaled the Senate Banking Committee that it should not link passage of the Stock Market Reform Act of 1989 (S. 648)—a vehicle germane to the stock volatility concerns underlying the current SEC/CFTC jurisdiction debate—to this issue. In your letter to Senator Dodd, you noted that "it makes no sense for Congress to delay passage of the important and much-needed S. 648 legislation, pending resolution of these [Working Group] discussions. We must address the problem of regulatory fragmentation, but we should do so separately from this legislation."

The futures trading practice reforms in S. 1729 are just as vital to the integrity of our financial markets as the stock market reforms in S. 648. In neither case does it make sense to delay the enactment of needed regulatory improvements until resolving the lengthy debate over SEC/CFTC jurisdiction. Yet, as with S. 648, we cannot de-link these issues from S. 1729 without a statement of support from you.

And so we ask:

Do you agree that passage of S. 1729 should not be delayed pending resolution of Working Group discussions over the jurisdiction matter; that concerns over regulatory fragmentation should be addressed separately from S. 1729?

Thank you for your prompt consideration of this matter.

Sincerely,

PATRICK LEAHY,
Chairman.

RICHARD LUGAR,
Ranking Minority Member.

THE SECRETARY OF THE TREASURY,
Washington, May 8, 1990.

The Honorable PATRICK LEAHY,
Chairman, Committee on Agriculture, Nutrition, and Forestry, United States Senate, Washington, DC 20510

DEAR MR. CHAIRMAN: Thank you for your earlier letter asking whether the issue of regulatory fragmentation should be addressed separately from the "Futures Trading Act of 1989," which would reauthorize the Commodity Futures Trading Commission (CFTC) for 5 years. For the reasons set forth below, we believe that this critical additional issue should be considered at the same time as the CFTC reauthorization. As a result, the administration will submit proposed legislation to Congress within the next week to reduce the problems associated with regulatory fragmentation. Let me explain why.

It is urgent that Congress reform the disjointed regulation of the markets governing stocks, stock options, and stock-index futures. If we do not take the necessary steps to correct the problem now, we are more likely to see minor events trigger major market disruptions like the ones we experienced in October of 1987 and October of 1989—and we will not have the regulatory tools we need to help contain the risk to this country's financial system.

The interaction of the recently created stock-index futures with stocks and stock options has contributed to major market disruptions with serious regulatory consequences:

—*Major Market Breaks.* In the 52 years between 1930 and 1982 (the year stock-index futures began trading) the Dow Jones Industrial Average declined by more than 6 percent on only three occasions: when the Germans took the Netherlands in May of 1940 (6.8 percent); when they encircled the Allied Forces at Dunkirk just days later in the same month (6.8 percent); and when President Eisenhower suffered a heart attack in September of 1955 (6.5 percent). As the futures markets have grown, such massive one-day selloffs have occurred four times in the last 3 years:

October 19, 1987—22.6 percent
October 26, 1987—8.0 percent
January 8, 1988—6.9 percent
October 13, 1989—6.9 percent

None of these days corresponded with any major news events like the ones before 1982. But they all shared the characteristic of enormous selling pressure from the stock-index futures markets.

—*Clearance and Settlement Breakdown.* After the October 1987 break, the clearance and payment system fell over 6 hours behind its normal payment times, with Chicago clearinghouses owing over $1.5 billion to investment houses. Had these funds been missing for any significantly longer time, it would have unleashed a chain reaction of events where other payments to other creditors would not have been made. This brought the financial system to the brink of breakdown; it was that close.

—*Dangerously Low Futures Margins.* Futures traders can control so great an amount of stock with so little of their own money that relatively small amounts of capital can concentrate enormous selling pressure on the stock market—great enough to punch a hole in the fabric of the financial system. Prior to the October 13, 1989 break, a professional trader in the futures market with $50,000 in cash could control almost $2 million in stock, which is nearly 10 times more than the $200,000 that a professional trader in the stock market can control with the same amount of cash. Many observers were astounded that, while stock-index future margins were increased temporarily in the wake of the October 1987 break, they were actually lower in October of 1989 than they were in October of 1987. Since these margins are set by the futures industry, not a single regulator, there is no way to harmonize margins between futures and stocks to protect the public.

—*Evasion of Short Selling Restrictions.* For over 50 years the securities laws have restricted bear raiders like the 1920s' Jessie Livermore from selling short in declining markets. The purpose of these restrictions is to prevent "gunning" the market, which drives down the market and confuses the small investor. However, a concerted selling effort in the futures market can completely undermine the short selling restriction—and in fact, because of low futures margins, can accelerate the stock market downdraft and increase public confusion.

—*Barriers to Innovation.* The Commodity Exchange Act (CEA) currently includes the so-called "exclusivity" clause, which requires that *any* financial instrument with *any* degree of "futurity" must be traded on a futures exchange. This has stifled innovation by preventing the development of new "hybrid" products that are simply not amenable to trading on a futures exchange. The result has been protracted litigation over what constitutes a "future"; an inability to trade in U.S. markets; and the shifting of innovative products to foreign markets. This is precisely what happened to Index Participation Certificates, which now trade in Toronto rather than the United States.

—*Ineffective Intermarket Enforcement.* With two different regulators, there is no effective way to prevent manipulation and fraud in transactions between the stock and futures markets. As a result, it is extremely difficult to detect the specific practice of intermarket "frontrunning," where a trader trades ahead of his client knowing that the client's trade will drive the market in a particular direction.

These consequences result from a failure to recognize the fundamental reality that stocks, stock options, and stock-index futures are all parts of "one market." This "one market" concept was thoroughly discussed after the 1987 collapse and is accepted by the overwhelming majority of scholars and market participants. Because it is "one market," it should have one regulator to coordinate and harmonize conflicting rules that create such substantial risk to the financial system as a whole.

Every other country with major trading in stocks and stock-index futures has a single regulator to make sure their financial system as a whole is protected. In fact, when the Japanese set up their futures market a few years ago, after detailed study of the U.S. futures and stock market system, they specifically established regulation of stocks and stock-index futures in one agency. We should, too.

In short, we should take the steps now to unify and harmonize regulation to reduce the likelihood that minor events will precipitate major market disruptions—and to have the tools in place to contain systemic risk when such disruptions do occur.

One remedy could involve the more substantial action of merging the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC), as some Members of Congress have suggested. Another would shift the regulation of all financial futures from the CFTC to the SEC. However, both of these proposals involve major regulatory changes that are more sweeping than is necessary to address the problems we now know about.

Instead, the administration supports a less sweeping approach that would only unify regulation of the "one market" of stocks, stock options, and stock-index futures. The proposal the administration will submit will:

—Shift regulatory authority for stock-index futures to the SEC, but in a manner that minimizes the disruption to the current operation of the markets in these instruments;
—Provide the SEC with oversight authority over the futures exchanges' ability to set margins, which would be similar to its current oversight authority over margin-setting by the options exchanges (there would be no pre-set minimum margins established by statute);
—Modify the "exclusivity clause" of the Commodity Exchange Act in order to end pointless litigation and remove barriers to innovation that are driving new products to foreign markets;
—Provide for appropriate transition; and
—Mandate reports within 18 months on any additional modifications that are necessary for the efficient regulation of the "one market" of stocks, stock options, and stock-index futures.

The administration believes that this is the most appropriate approach for addressing regulatory fragmentation with the least disturbance to and best protection for the futures markets. Moreover, it would have no effect on the agricultural community, since stock-index futures have no relation to agricultural products or agricultural futures.

The proposal would also minimize the effect on the CFTC, because stock-index futures represent less than 10 percent of the futures volume under CFTC jurisdiction. Indeed, the CFTC will be able to concentrate its considerable expertise on the more traditional agricultural and financial futures products that have long been the core of its jurisdiction.

I urge the Senate to speedily confirm Chairman Gramm for another term, so that the CFTC will have the leadership necessary to address these matters successfully. Led by Chairman Gramm, I believe the CFTC will continue its outstanding job of ensuring the integrity and safety and soundness of the markets it regulates.

Thirty-five years of working in the markets have brought me to the conclusions outlined above. I understand and appreciate your strong concerns about this issue, and look forward to working constructively with you on the administration's proposal.

Sincerely,

NICHOLAS F. BRADY.

Senator GORTON. Chairman Breeden, the same question in just a slightly different formulation: Why, in your view, is it either better, more effective, more efficient to give the SEC jurisdiction over stock-index futures rather than to rely on coordination and cooperation between two separate independent agencies?

Mr. BREEDEN. Well, Senator, I would like to at the outset associate myself with Chairman Greenspan's comments concerning the job that Chairman Gramm and the CFTC have done. We share the view that this is not an issue of one agency doing a better job than another. It's a question of structure and whether the structure that we now have is as good as alternatives in helping us deal with the potential for fraud and for serious instability in the clearance and settlements system when we have market crises. It is not the issue of volatility. With due respect, the issue of volatility is a bit of a strawman; the real issue is whether the low levels of margins (near zero) when we hit a crisis point make the stress on the system infinitely greater.

Concerning the question of whether the current system is a good one in promoting competition, it has helped to do that. But it has also over time allowed barriers to competition, very serious barriers, to develop. So, for these and a number of other reasons, we believe that a system parallel to that in place in England, in France, in Japan, and in all the other major countries that we compete with, where a single agency is able to regulate stocks, options, and derivatives on stocks, would be the best possible system. We would promote competition. We would be better able to deal with

fraud. And we think we, particularly by changing this margin system, would do a much better job in protecting the stability of the market for the American public.

Senator GORTON. Thank you.

Mr. Chairman, I want to thank you for calling the hearing and for this opportunity to ask questions and simply to associate myself with your remarks and those of Senator Lugar, that it is time to bring this to a head, and I will certainly cooperate with each of you in attempting to see to it that we can do so in an orderly fashion on the floor of the Senate.

The CHAIRMAN. Thank you very much.

Senator Kerrey.

Senator KERREY. Thank you, Mr. Chairman.

Just for the record, Chairman Breeden and Chairman Gramm, I must tell you that I have a rather low opinion of the job that the SEC and the CFTC have done. It seems to me that what we have here is an unfortunate public display of a jurisdictional conflict with minimal compelling evidence that we should transfer jurisdictional authority. That is the conclusion that I have reached.

Chairman Breeden, you referred on a couple of occasions to the observation that you have made that there is fragmented regulation. That seems to be a rather important thing in your mind that we should eliminate. Do I have that correct? Do you observe fragmented regulation to be something that we ought to work vigorously to eliminate?

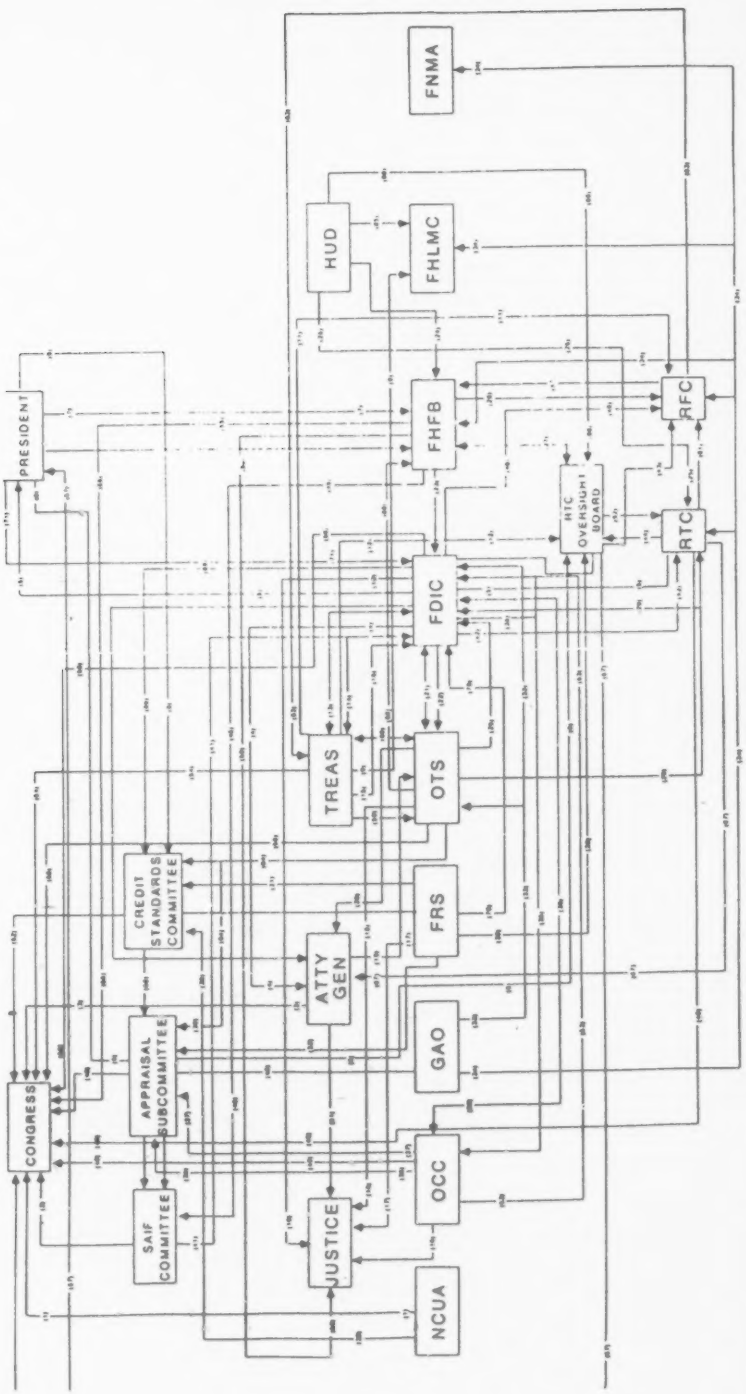
Mr. BREEDEN. I would agree with Chairman Greenspan, having really looked at some of these issues for years, that there are benefits to having a regulatory structure in which there is a certain amount of decentralization, in which we do not have a single agency that makes every decision about every financial product. I don't think anyone here is suggesting that.

But at some point decentralization becomes very unproductive, and at some point you do need to get a consistent answer to problems that cut across product lines. And that, clearly, in my judgment, is the case in the regulation of stocks, options on stocks, and futures on stocks.

Senator KERREY. I have difficulty with the fact that you have isolated this particular area of fragmented regulation. I know that you were very actively involved in the drafting of FIRREA legislation. I have here a diagram of the regulatory lines of authority established under FIRREA, and it seems to me to be a textbook example of fragmented regulation. It seems apparent, to me at least, that this bogey of fragmented regulation didn't frighten you off when you drafted that particular statute.

[The diagram of the regulatory lines of authority established under FIRREA follows:]

DIAGRAM OF THE REGULATORY LINES OF AUTHORITY ESTABLISHED UNDER FIRREA



Mr. BREEDEN. Well, Senator, with all due respect, the chart was much simpler when we sent the bill up than when it came back down to be signed.

Senator KERREY. Oh, we loused it up, is that it? [Laughter.]

Mr. BREEDEN. Concerning the issue of how complicated that statute became, I think there are a great many people who had a role in that.

The CHAIRMAN. Did you recommend a veto of it then?

Mr. BREEDEN. No, absolutely not.

The CHAIRMAN. I just wanted to check.

I'm sorry I interrupted the Senator.

Senator KERREY. Well, I am genuinely trying to listen to all the presentations and consider whether or not this transfer of authority should occur. And I do not find a compelling case that there is something that needs to be done immediately to avoid a regulatory environment that is going to limit innovation and restrict the flow of capital and make it difficult for us to compete internationally and all that sort of thing.

I just don't see the documented case being made, and as a result I conclude that this is essentially a jurisdictional battle. And as I said, with all due respect, and as Secretary Glauber himself said, the CFTC is doing a good job under the circumstances. There is in that statement some extenuation that I have made as well in my analysis of the job that is being done.

But if you look at just the last 5 years of activity at the SEC and the CFTC, one has to push hard on extenuating circumstances, I think, to reach the conclusion that a good job has been done.

The CHAIRMAN. Senator Fowler.

Senator FOWLER. Well, let me follow up a little bit, since the Senator from Nebraska's time is up—or he stopped, uncharacteristically. [Laughter.]

But I was listening to him.

Secretary Glauber, I was also listening very closely to your regulation answer to the Senator from Washington. If we gave the regulatory authority over stock-index futures to the SEC, do you think that SEC would be able to prohibit 100-point swings?

Mr. GLAUBER. What I did say in my statement and what I would like to try to emphasize is that the regulatory structure leads in a variety of directions to the potential for market disruptions and for a reduced set of tools to deal with those disruptions when they occur.

In particular, I am talking about the need for better-integrated clearance and settlement, better-integrated circuit breakers, tools which would help us deal with those disruptions as they evolve and when they occur.

Senator FOWLER. Well, I know you were listening to my friend from Indiana talk about those externalities. You are not making the case—I know you were very careful not to make the case in your prepared testimony—but again, your answer to Senator Gorton leaned heavily on the fact that somehow the regulator would have more weight than market forces in the final result. I assume you don't really believe that?

Mr. GLAUBER. Senator, I certainly did not want to suggest that market forces can be overridden. What I did want to suggest is that

I think when market forces occur, we need to have in place the tools to deal with them and we are more likely to have them with unified regulation.

If I might also just take this opportunity to comment on something that Senator Lugar asked broadly before, but we moved on to other things. That is the issue of volatility.

I could not agree with you more that there is no good evidence that average volatility levels have increased recently or that there is a relationship between average volatility levels and margin levels. I think it would be very hard to measure it if it did exist, because there are so many other things going on.

But it really isn't average volatility that concerns me or concerns the Secretary. It really is this potential for these brief, violent periods of market disruptions, when the pricing mechanism between the stock market and the futures market seems to come apart and when we get really totally disoriented kinds of results, when futures prices are selling at a 250-point discount to stock prices, when instruments cannot be opened for trading successfully because of the supply demand imbalances.

I think this is something quite different from average levels of volatility. I think the analogy I would make is to a river whose average level is perhaps 2 inches but in which somebody could easily drown because they had happened to be in the part of the river that is 20 feet deep.

So I don't think we should look at average levels of volatility nor rest assured because average levels of volatility have not increased. I think there is something of quite a different phenomenon going on here.

Excuse me for diverting, Senator Fowler.

Senator FOWLER. You are excused.

Mr. GLAUBER. Thank you, sir.

Senator FOWLER. What is it, why don't you itemize for us what you would do differently?

Mr. GLAUBER. Well, I tried in both my spoken statement and the written statement to catalog the areas in which I think we have unharmonized, uncoordinated market mechanisms like margins, but beyond margins——

Senator FOWLER. You have seen those studies by the Fed, I am sure, that do not support your thesis that higher margins will decrease volatility.

Mr. GLAUBER. That, again, Senator, is not really the thesis. What we have said is that we need margins set by the exchanges but overseen by a Federal regulator, in order to make certain that the entire financial system is not exposed to disruptions.

What is done in one marketplace can disrupt other marketplaces, and therefore there needs to be coordination. I don't want to suggest—and perhaps, by the way I spoke, I misled—that there is——

Senator FOWLER. Nobody is arguing that there shouldn't be coordination. The question comes back to what Senator Kerrey said, and even though it is denied in Secretary Breeden's testimony and, by implication, everyone's, is this not a turf battle? It just continues to walk like a duck and quack like a duck and act like a duck.

We are for coordination through the CFTC. We have taken all these audit trails, much more stringent capital requirements, price limits. SEC is just now coming around to ask for some of these things. They weren't leading the pack, despite the historical review that Chairman Breeden gave us in his testimony.

But I have been here trying to listen, and it's not very compelling.

Let me ask Chairman Breeden a couple of questions. And we don't know each other, but I might as well say it man to man, I appreciate your restrained printed testimony, but it doesn't help matters, it doesn't seem to me, in your Saturday interview in the New York Times, where it looks to me like a good example of the pot calling the kettle black. You start jumping on the Congress. We, at least this committee, has been working on this problem for 18 to 20 months.

If you look at the S&L's, we met the President's request as the number one order of business last year, when you were involved, was to get an S&L bill. They said do it in 90 days; we did it in 90 days. They just got around to appointing the head man a year and a half later. That's not the Congress' fault.

It seems to me if we want to work out this situation in the public interest, including full disclosure and as much requirements and oversight as we can have to keep confidence in the markets—whether they are located in New York or Chicago, I might add—that this business of firing shots across everybody's bow and bragging that you can do it better, especially after what has been happening, the scandals that have plagued the markets in recent months, again it's not very compelling way to approach public policy.

I would be glad to have your response. I know that was lengthy. But I am responding. This a congressional response, one congressional response to your interview. I give you maybe the last word and maybe the next-to-last word. [Laughter.]

Mr. BREEDEN. I have been in these events often enough to know it won't be the last word on this side of the table, Senator.

I am glad you raised that article because I had been hoping to have a chance to respond as well to Senator Leahy's initial comments. I think, since everybody has expressed great interest in this, it might be useful to put in the record along with everything else the specific article, because I think the remarks have been variously characterized incorrectly.

The CHAIRMAN. I will put it as an addendum. I think, in fairness to you, Mr. Chairman, that it should be in the record, the whole thing. If you will give us a copy, we will put the whole article in the record.

[The New York Times article, "S.E.C. Chief Concerned About Futures Debate," dated Saturday, May 5, 1990, follows:]

S.E.C. CHIEF CONCERNED ABOUT FUTURES DEBATE

(By GREGORY A. ROBB)

(Special to The New York Times)

WASHINGTON, May 4—Richard C. Breeden, the chairman of the Securities and Exchange Commission, said today that there were "disturbing parallels" between

the debate about who should have regulatory jurisdiction over stock index futures and the debate before the savings and loan crisis.

In an informal meeting with reporters in his office, Mr. Breeden said that both policy disputes were filled with the "vocal determination of the interest group that perceives itself to benefit from the current system to avoid any change."

He said that another parallel was the amount of risk to the financial system if the problem is not addressed soon.

Action Said to Come Too Late

"The thrift problem grew for decades and Congress didn't act on that problem until that problem reached much more serious dimensions," he said.

Referring to the stock market collapse of October 1987 and the sharp drop in the market in October 1989, Mr. Breeden asked, "How many times should we have the phenomenon before we take reasonable, modest steps to produce greater stability in the system?"

Mr. Breeden was the chief architect of the Bush legislation to resolve the savings and loan crisis before he moved to the commission.

His comments were a response to recent criticism by Wendy L. Gramm, the chairman of the Commodity Futures Trading Commission, that the S.E.C. is engaged in "regulatory imperialism" and simply grappling for control of successful products.

Her comments have been widely echoed by the futures industry.

"This is a policy dispute," Mr. Breeden countered. "This isn't a question of turf. I hope that rather than trying to polarize debate, people will focus on the merits."

Testimony Set for Tuesday

Both Mr. Breeden and Mrs. Gramm will appear before a Senate Agriculture Committee hearing Tuesday on the jurisdiction issue, along with other members of what is known as the White House Working Group.

All members of the group, except Mrs. Gramm, have endorsed giving the S.E.C. the new power, a fact that Mr. Breeden is quick to point out.

"Irrespective of the decibel level of the one who disagrees with the conclusion, it's still three votes in favor and one vote against," he said.

Milken Immunity Plan Criticized

In other matters, Mr. Breeden expressed concern about the intention of Representative John D. Dingell, the chairman of the House Energy and Commerce Committee, to grant immunity to the convicted financier Michael R. Milken in return for his testimony.

Mr. Dingell has said that he would like Mr. Milken to appear before his investigations subcommittee during the summer, before Mr. Milken is formally sentenced for his recent guilty plea to six felony counts.

Mr. Breeden said, "If you have immunized testimony before a point in time that the plea agreement becomes irrevocable on the date of sentencing, it does create potential for introducing complications into the case."

Response From Dingell

When informed of Mr. Breeden's comments, Representative Dingell said that he was aware of the S.E.C.'s concerns and would work closely with the agency, but he added, "The subcommittee intends to perform its duties and oversight with vigor."

Mr. Breeden said that the S.E.C. was studying a recent ruling by the United States Court of Appeals for the Second Circuit that challenged the S.E.C.'s legal theories about what constituted insider trading. He said that the agency could ask for a rehearing of the case or seek to bring it before the Supreme Court.

"We're not happy about it and we're still looking at it," said William R. McLucas, the S.E.C. enforcement chief, who sat in on the briefing.

Mr. Breeden also said that the S.E.C. had not reached a formal decision about how to respond to the strict anti-takeover law that was recently enacted in Pennsylvania.

Mr. BREEDEN. I want to make very clear that my remarks for the article did not suggest that there were parallels between the disgusting degree and extent of fraud in the savings and loan industry and any other industry, most particularly futures trading.

I did not, as Senator Lugar has suggested, say that there was a close analogy between the savings and loan problem and this one. I did not, Senator, as you suggested, blame the Congress for that problem.

I simply said, and the exact words were, that there were some "disturbing parallels" between the debate about that situation and this one. And there are some parallels. I am not claiming or suggesting, and never have, that there was a close connection here between these two problems or that they are directly analogous.

But there are some parallels. In the thrift situation, for years and years that problem grew, and there were a number of attempts, including suggestions by the Secretary of the Treasury, to cure that problem, to begin to take steps, and it took years in order for our process to begin to react. That was not solely a fault of the Congress, although Congress is one element of it. Certainly the administrations and regulators also had a part in that. But the process was very slow, and the end result was billions and billions of dollars in damage to the public before action was taken.

There also was a significant amount of debate about leverage. The thrifts argued that they ought to be able to compete with much lower levels of capital—2, 3 percent, sometimes close to zero. Similarly, the futures industry is arguing, I gather, with our suggestion that we should reform a system that allows 98 percent leverage in the positions that are carried in the stock-index futures markets.

There ought to be a little more investment made by the people carrying these positions than there is. And that is a parallel to the degree, the extraordinary degree of, if you will, hyperleverage that existed in the thrift situation. And, while there are differences, one of the strongest cases, we think, for some change in this area, is to correct the overleverage in the current stock-index futures situation.

In fact, that is a view that we are not alone in holding. The Treasury Department has expressly stated the same concern. Chairman Greenspan stated in his Senate testimony that he was shaken by the events last October and the need to very sharply raise futures margins in the midst of the crisis.

The president of the Federal Reserve Bank of New York, Jerry Corrigan, in a recent speech said, and I quote, "I believe that margins in many financial-type futures instruments are typically, if not systematically, too low. In the case of the S&P 500 contract, for example, it seems to me that a significantly higher margin, perhaps as high as 15 percent or so, is always called for."

So we are not alone in suggesting that leverage is a problem and that it creates a risk for the system. It is a risk we don't have to run. The futures markets did carry much higher margins for a year after the 1987 crash. It didn't drive trading to Japan. It didn't cause a destruction of the marketplace. It was a prudent thing to do, and we ought to continue that. I have simply tried to urge that Congress and the regulators, hopefully working together in a partnership, should try to identify where there are risks and where we can improve our system.

You cannot really argue, or at least I wouldn't argue, that the current system is the best we can do to control fraud, to control

risks to stability, or to make a competitive system in which we minimize the regulatory hurdles and let people get out and compete in the marketplace.

Senator FOWLER. Were there literally thousands of complaints filed against the securities professionals after—since you brought up the 1987 crash—stemming from the alleged abuses on options, derivative products that the SEC regulates?

Mr. BREEDEN. I would be happy to provide you with the number of complaint letters.

Senator FOWLER. But you know. You know the answer to that. I am not asking for the exact, but it was in the thousands. At least that is according to my information.

Mr. BREEDEN. I know I have had 14,100-and-some letters since the October events, from individual investors all over this country, demanding that we do something about the shocks to the securities markets and what they see going on in index arbitrage and some of these practices. So we get a flood of letters on all kinds of topics, and I would be happy to give you the statistics.

Senator FOWLER. Well, I just think it's just very interesting to me, and I allowed you to give your full defense, which I appreciate, to the article. But again, it belies the tone which you used, and there were no specific suggestions in this article, not a single one. It was a broad-based attack, saying, "I am not trying to polarize. We are just going to focus on"—no discussion of the merits. And then your first quote was, "Blaming the Congress for failing to act."

Mr. BREEDEN. Senator, you know, as I do, that we can't control what the reporters choose to write.

Senator FOWLER. Oh, I see. I see. I see.

Mr. BREEDEN. We have been discussing, and I have discussed at length with the committees and with reporters the substantive problems. Our testimony is filled with that discussion. We have chosen to do that, and we have consistently done that. You can characterize it however you wish; that is certainly your right. I didn't intend any attack on anyone. We have tried to discuss this as the serious policy issue we think it is. We think that the marketplace is placed at risk unnecessarily by some of the practices that exist, and we think we would be remiss as regulators if we didn't advise the Congress of that fact.

Senator FOWLER. Well, I appreciate that. But as one who has spent 14 years in the Congress, all I can say is I would like to have a Chairman and a regulator who speaks with specificity to the press and ought to know better, if you are going to claim that you were misquoted. Especially since you are given credit for being one of the architects of the S&L provision, you knew exactly what you were doing.

And I do not think that that helps the process that we are undertaking, the job of this committee, that we have been working on for 18 months, all of a sudden you weighing in with specific words that cannot be misconstrued: Congress didn't act; blaming Congress; talking about polarization when there has not been any polarization evident, I can say to the chairman and the Ranking Member, coming out of this committee.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Boschwitz.

Senator BOSCHWITZ. Thank you, Mr. Chairman.

The CHAIRMAN. And then Senator Bond. I am sorry I gave the order the wrong way before, but I have found my notes. It's sort of like extricating one of the Dead Sea Scrolls. I found my original lists, and I do remember your being there warming that seat in your distinguished fashion, Senator Boschwitz. So you are next, and then Senator Bond.

Senator BOSCHWITZ. Thank you, Mr. Chairman.

Let me say, Mr. Chairman, I am a great admirer of the financial markets of this country. I also very much agree with the statement by Senator Lugar that he made at the outset of his questions.

I have participated in the financial markets of this country over my adult life and indeed even as a kid because my father was a stock broker for Paine, Webber, Jackson & Curtis for many years, and I used to go down to the exchange as a child and grew to like it very much.

Let me tell you, Chairmen Breeden and Dr. Gramm and also our chairman, that I am very disturbed to see this jurisdictional fight between these two agencies.

I would repeat Chairman Greenspan's final words when he said, "We should not lose sight of the fact that under the existing system of split jurisdiction over financial instruments, our financial markets have been the most innovative in the world, with many of the new products spurred by the introduction of index futures and other futures."

The kind of jurisdictional fight, as I watch them here in Washington, gets pretty fierce. Let me say to both of you, but particularly to you, Mr. Breeden, that this Senator is going to very carefully watch, very carefully watch, what you do. As a matter of fact, I have hired a staff person who has a master's degree in the futures market for that purpose.

Agencies have a way of biting at one another. Agencies sometimes aggressively attempt to make one another look bad in an effort to increase jurisdiction. The turf war led by the SEC that intends to gobble up the CFTC better not become one where the SEC seeks to make the other agency look bad. Our financial markets are too important. Our financial markets are too fragile to be subjected to ambitious regulators.

So I will watch, and I will ask others to do the same, and my staff to do the same as well, not only on this committee but also on the Banking Committee.

I know you will tell me and tell others on this committee that you are just trying to improve the system. From where I sit, both your agencies have their problems, as the Senator from Nebraska said, and I join him in his remarks.

Those who enter turf battles that endanger markets, which I think are the underpinning of the financial elements of our Nation, really do so at their own risk.

I would ask Mr. Glauber, you say that you feel that a single agency would be more streamlined. But what reason have I to believe that a bigger agency is going to be an agency that is going to be able to act more effectively or quickly? Mr. Breeden said in his

testimony, "All monopolies create inefficiencies, and this is no exception."

Mr. BREEDEN. The exclusivity clause.

Senator BOSCHWITZ. Pardon me?

Mr. BREEDEN. The exclusivity clause of the Commodity Exchange Act.

Senator BOSCHWITZ. In referring to the exclusivity clause, which is not totally exclusive. In referring to that, "All monopolies create inefficiencies, and this is no exception." Why would this larger agency be more streamlined? Why would it be able to act faster and more effectively?

I find around here the larger the agency the more difficult they are to deal with.

Mr. GLAUBER. Well, Senator Boschwitz, as you know, we have proposed really the minimalist approach to trying to deal with just these problems, and that is to move jurisdiction of stock-index futures to the SEC, and not to combine the two agencies, which I think would suffer, has certainly the potential of suffering, from the concerns you raise.

I think the reason it would work better is that regulation then, the structure of regulation, would follow the economics of the way the markets are working. I think as long as we ask two regulators to try to regulate one market, it has to lead to inefficiencies. And that is why I said I think it would be more streamlined and effective.

Senator BOSCHWITZ. Well, my experience is the larger the agency, the less streamlined it is and the more difficult it is to operate with.

Let me talk about margins. What are the present margins in the United States on futures compared, for instance, to the Japanese margins? Are you familiar with that, Chairman Breeden?

Mr. BREEDEN. Yes. The margins in Japan—and they differ somewhat between the Nikkei index and the Topix index contracts—require a minimum. The margin must be the greater of 6 million yen or 9 percent at current times. The 6 million minimum applies to some transactions and not to others. In some cases, that results in a margin that may be as high as 26 percent if you're applying the 6 million yen minimum to the current value of the contract. Otherwise, it's a 9 percent level.

Senator BOSCHWITZ. That's for customers. What about the members?

Mr. BREEDEN. I'm not certain. I believe it's 6 percent for members at the current time.

Senator BOSCHWITZ. Then how does that compare with American margins?

Mr. BREEDEN. Well, we have a very complex system. The basic comparison is that in Japan, the Government of Japan oversees the establishment of the margins on futures, options, and stocks through the Ministry of Finance. And in the United States of America, only stocks and stock options are overseen by the Government, and the safety of the marketplace in the case of stock-index futures is not under any direct U.S. Government oversight, but is left totally to the private boards of directors of the futures exchanges. And we have felt that that disparity is a weakness.

Senator BOSCHWITZ. I asked what the margins were in the United States. And the margins in the United States are certainly comparable to what they are in Japan as percentages.

As I understand margins, the margins in the futures transactions—and perhaps Chairman Gramm can also comment on this—but the margin on a futures transaction pretty much covers the entirety of the risk, and very often is larger than the risk. And it changes on a daily basis. Is that not correct? The entire exposure is covered by the margin, not the entire value of the underlying commodity that is covered by the contract, but the entire exposure. Is that not correct?

Dr. GRAMM. I am not sure that I understand the question, the entire exposure of it.

Senator BOSCHWITZ. The exposure as the market goes up and down, let's say, on a corn contract or on a futures contract. The margin is increased if the——

Dr. GRAMM. You are probably referring to just the futures-style margining, where, if the market moves against you, you make additional payments. That's right.

Senator BOSCHWITZ. As a matter of fact, you have to keep the moneys on deposit there.

Dr. GRAMM. That's right.

Senator BOSCHWITZ. So that the entirety of your exposure, as I understand it, is covered by the margin, is it not?

Dr. GRAMM. The entirety of the moves, the market moves.

Senator BOSCHWITZ. That's correct. The entirety of the movement.

Dr. GRAMM. That's right.

Senator BOSCHWITZ. It's not clear to me why it's necessary to increase that margin, Chairman Breeden. Have we characterized margins correctly?

Mr. BREEDEN. No, I don't think you have, Senator. And the comparison with Japan is also skewed by the fact that they have 3 percent price limits there and, thus, margin plays only a portion of the role in dealing with extreme price movements. We don't have any comparable limits in the United States.

Senator BOSCHWITZ. They have 3 percent price limits on stock-index futures?

Mr. BREEDEN. Limits on moves in the futures price, yes, sir.

Senator BOSCHWITZ. Within a given day?

Mr. BREEDEN. In a given day. Yes. And we don't have such a stringent system. So that margin doesn't play as large a role in Japan as it does in the United States, because they have something additional that we don't have: these strict price move limitations.

Senator BOSCHWITZ. But as that exposure increases, it's my understanding that there may be margin calls three, four times a day.

Mr. BREEDEN. There can be. And that is what creates the risk. That is what Secretary Brady, Chairman Greenspan, New York Federal Reserve Bank President Corrigan, and I have all pointed out is the weakness. It's the fact that, if you go into a crisis having set your margin based on a normal day, and you enter a problem day at 2.2 percent, as we did in 1987 and as we did in 1989, then it becomes necessary to sharply and dramatically raise that margin right at the time when the market is in the midst of the crisis.

And that then requires payments, substantial payments. On the afternoon of October 13, 1989, it was more than one-half billion dollars in payments that were required in the stock-index futures market because of increases in that margin rate.

Well, the moment the market is in its worst crisis, and you're hoping it's going to bounce back, is an unfortunate time to be collecting one-half billion dollars in extra margin. That is catch-up ball, if you will, because you started too low. And that's the risk that we could avoid. That just creates a little too much risk that we don't need to carry.

No one wants to set margins that are at levels that are punitively high. No one wants to try to make it uneconomic to trade stock-index futures. But what we have suggested is that it would be possible to set some level of floor so that we are not trying to carry 98 percent leverage in a $20 billion market. Jerry Corrigan has suggested 15 percent, and I have suggested 20 percent, but I would be happy at 15 percent.

Senator BOSCHWITZ. Do you want to comment on that? Were there any restraints in the trading that occurred on October 13? Did people have trouble making the margin call?

Dr. GRAMM. Absolutely not. Let me clarify for the record, margins are not set based on an average day's move. Basically the way they are set for prudential purposes at the exchange level is to cover 95 to 99 percent of all moves over the preceding 6 months. And so it's not just an average day's market move that would be covered.

Chairman Breeden suggests that the additional margin that was collected on October 13 and then on October 16 created a liquidity problem and the need to liquidate futures positions to meet the margin calls. There is no evidence of any problem in collecting those margins. They were increased $1,000 a contract on October 13, and phased in with another $1,000 a contract on October 16.

I would just raise a question in terms of consistency of setting margins. The SEC does have the authority over the margins on the OCC and the CBOE. If the SEC had extreme concerns over the margins of the S&P 500 futures, I question whether or not they shouldn't have looked at the market over which they do have margin authority and cause them to increase the margins when they felt the margins were low early that summer.

In fact, the margins on the OCC and the Chicago Board Options Exchange, which are under the SEC control, have pretty much marched in sync with the S&P 500 futures margins.

So I really have a question about where the inconsistencies are. If there are concerns over inconsistencies in futures margins and stock margins, why isn't there concern about inconsistencies between option margins and stock margins on the exchanges that the SEC regulates?

In fact, as we have said many times before, the margin collections were made. There were no financial problems either in October of 1989 and, in fact, as far as financial integrity of the futures markets, in 1987. They fared much better than the derivative markets overseen by the SEC.

Senator BOSCHWITZ. On volatile days in the stock market, it's my understanding that the procedures of the New York Stock Ex-

change make it very difficult to keep up with the volume of trade, and that trading of futures gives, in a way, an ability to keep up with the market or to get ahead of the market.

I know that I read in the Economist that the futures market was thought to limit the downward plunge of the Japanese stock markets, but they apparently reached a different conclusion there with respect to futures trading than here.

But am I mistaken that the stock exchange has more difficulty? I believe the stock exchange, the New York Stock Exchange, has more difficulty in absorbing the very large volumes on these very volatile days and that they are helped by the presence of the futures index and the ability to trade those.

Yes?

Mr. BREEDEN. Senator, I would want to make very clear that we think the financial futures markets, and the stock-index futures markets in particular, are extremely valuable to the overall capital markets.

I have said in my written testimony, and I am happy to say orally, that there is no question that the ability to hedge in those markets is of great benefit to many investors in the stock markets. So there is absolutely no question of anybody at this table suggesting that they are not valuable.

In the margin debate that you are raising, it is a question of whether the Government should have any role in overseeing these practices, and we think it should.

Senator BOSCHWITZ. Let me ask the question again because you seem to have missed it. On days when there is a very large amount of trading and a great deal of volatility, I am told that the stock exchange, the New York Stock Exchange, has difficulty in keeping up and that they are in fact aided by the abilities to trade these futures contracts because some of the horseshoes—if that's what they're called—or were closed down on the particularly volatile days. Am I correct that the futures, the trading of futures can operate more quickly and therefore more quickly establish a base?

Mr. BREEDEN. You have asked several different things. You are not correct that the stock market has greater trouble processing transactions. That was something that happened in 1987. Actually, both New York and Chicago had some trouble then. The New York Stock Exchange found its order reporting systems computer capacity very severely strained, and it took 6 hours for some of the margin payments to be made for transactions on the Chicago Mercantile Exchange. By 1989, both exchanges had invested considerable amounts in their computer processing capabilities, and I think both exchanges, the New York and the Merc, do an excellent job of processing customer order flow.

Senator BOSCHWITZ. Would you comment on that, Chairman Gramm?

Dr. GRAMM. I think what you are referring to is the fact that in a rapidly moving market, it can be more efficient to move into the futures markets, take a position temporarily in stock-index futures, and then go back to the stock market and make those transactions at a slower pace. That is a tool that is used by a large number of institutions.

Senator BOSCHWITZ. Thank you. Pardon me for interrupting you.

Thank you, Mr. Chairman. I would say again that I trust that there won't be a turf battle that is in any way going to impose itself on markets or injure markets. I would say to the witnesses that it is absolutely essential that that not occur. These markets need to be protected and they are vital to our economic well-being. In the event such a fight were to start, there are lots of folks in London and Tokyo who would love to have a larger share.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Boschwitz.

Senator Bond.

Senator BOND. Mr. Chairman, since I have the distinct pleasure of serving on the Banking Committee, I will assure you and the witnesses that the testimony is just as exciting and thrilling and complex as it was before the Banking Committee.

The CHAIRMAN. No, no. It was more interesting, I thought, before the Banking Committee. Think back, if you wish, to who testified there. [Laughter.]

I just mention that. You still have a few amendments to come up on the farm bill. [Laughter.]

Senator BOND. I would like to ask Chairman Gramm, explain for me the view of the CFTC on the exclusivity clause. Just recently I have seen the focus more on the exclusivity clause, and I believe Secretary Glauber recommended modification or elimination of it. What do you see as its role and what would be your view of the impact of such action?

Dr. GRAMM. The exclusivity clause was placed in the Commodity Exchange Act early on in order to avoid a patchwork quilt of regulations that could occur in the trading of futures products, not only duplicative Federal regulation but particularly State regulation of futures transactions, the potential even for some gambling regulations that could come into effect. And therefore, the exclusivity clause was put in place in order to preempt potentially disruptive and confusing and conflicting regulatory jurisdictions among the States vis-a-vis the Federal regulator. And that was the primary purpose.

My concern about eliminating exclusive jurisdiction is that then you could have just that situation arise. These products, futures products, are traded by grain elevators and institutions around the country, and they would be very much harmed if a grain elevator in Kansas, for example, had to follow certain rules in Kansas even if they wanted to trade a contract on the Chicago Board of Trade or the CME, for example. So it is a difficult issue to deal with.

Senator BOND. I might ask Mr. Glauber if he has something he wished to add on that?

Mr. GLAUBER. I just would like to agree with what Chairman Gramm said. We are aware of the benefits of the exclusivity clause. What we would recommend is that it not be eliminated, but modified to retain some of those benefits but at the same time allow competition to develop between financial instruments on different exchanges.

Senator BOND. How would you modify it? To what extent would you modify it?

Mr. GLAUBER. We would continue to want to retain the benefits that Chairman Gramm pointed out. What we really would propose

is that there be open competition between exchanges on instruments, that if two exchanges want to trade similar instruments, that they get to trade them on each exchange under their particular trading rules, and that let the market judge what is the most effective venue for that instrument.

Senator BOND. Chairman Breeden, how would that work, if you have an exclusivity for products, products regulated by SEC? Tell us how that works in your area and what impact you would see from that kind of modification?

Mr. BREEDEN. Well, I think the proposal that the administration is making to limit the scope of the exclusivity clause would retain its preemptive effect. I apologize for using that word, for its sensitivity relative to our friends in the State regulatory community, but that is essentially what the exclusivity clause, in part, is. It is preemptive of the State's ability to have in the futures area what we have in the securities area, which is separate State laws, such as blue-sky laws.

We have not proposed in our testimony, and I understand from Secretary Glauber's testimony that the administration isn't proposing, to change that feature of the exclusivity clause. So the problem Chairman Gramm mentioned is not an issue. It isn't a question of whether a grain elevator somewhere is going to have to deal with State regulation rather than Federal. That is not the issue.

The issue is: Should that same exclusivity be applied to the Federal Reserve Board, to the SEC, to the New York Insurance Commission, to an agency, State or Federal, that is the primary regulator of another type of financial institution? And, in the case of a product like the IP's product we have been discussing, the solution we favor is to let it trade under the blue-sky laws and under the securities laws on the Philadelphia Stock Exchange, if that is where the product is developed, and to let it also trade in Chicago under the Commodity Exchange Act with the full benefits of the remaining preemptive effect of exclusivity, and to let the market decide what is the best place to trade the product.

We don't need to go to the courthouse for 4 years to decide where to trade the product. Let's let the market make that judgment.

Senator BOND. I am a little bit confused as to what remains of exclusivity if you are going to let it be regulated by blue-sky laws. Where are you drawing the line?

Mr. BREEDEN. A product that was listed on a board of trade under the Commodity Exchange Act would still not be subject to any type of State regulation. It would be under the existing system.

But the situation could be different for another type of product, such as a bank swap or a securities product that had hybrid features, or a convertible bond with pricing of the convertibility feature based on an index of some type. Even if a piece of that security might be alleged to be partially a future (and many securities products and securities transactions have some elements of a futures transaction, as do banking products and insurance products), if the primary regulator, in this case the SEC, licensed a product that might be argued to be 90 percent a security and 10 percent a future to trade under the securities laws, subject to the blue-sky laws, that would be legal.

At the same time, a competitive product could trade in the futures markets under the Commodity Exchange Act under that system. And investors could go to the CME to buy it, could go to the Board of Trade to buy it, could go to the New York Stock Exchange to buy it. That would be an open and competitive system and, if we believe in competition and innovation, why not let the marketplace decide those issues?

Senator BOND. How do you decide if you come up with a new instrument, you get to shop for it——

Mr. BREEDEN. Each regulator would, as they do today, decide to approve a product, whether it was a swap being issued by a bank, or an IP, which the SEC unanimously approved for trading on the Amex and the Philadelphia Exchange. That would be no different than today. The primary regulator would make those judgments about what the appropriate banking product was or the appropriate securities product.

But what we wouldn't have is this repeated litigation being brought asserting that, no, no, you can't trade that product because it is 10 percent or 20 percent a future or some element of the product involves some attribute of futurity. That, under the administration's proposal, would be eliminated. And I think we would have a much stronger, more competitive system, that would be fair to both sides. Products could trade in Chicago, and they could trade in New York.

Senator BOND. Let me turn back to Secretary Glauber. Maybe you can help me out in my confusion.

Mr. GLAUBER. Well, I wanted first to point out that there would be a difference under the administration's proposal, and that is whether the product traded in Chicago on a board of trade or in, say, New York on a stock exchange, if it were an equity derivative product, it would be under the regulatory jurisdiction of the SEC, under our proposal.

But the major point I was trying to make, I think Chairman Breeden was making, is that the exclusivity clause does a number of things. Currently it does, in particular, two things: It eliminates the jurisdiction of State authorities over contracts traded on a board of trade. But it also says that those contracts have to trade on a board of trade.

What we would propose in the legislation is to relieve the exclusivity clause of that latter requirement so that these contracts could trade, these instruments could trade either on a board of trade or on a stock exchange, trade under their particular trading rules and allow competition.

Senator BOND. Regulated, if an equity derivative, they would be regulated by the SEC?

Mr. GLAUBER. That is the essence of our proposal, yes, Senator.

Senator BOND. Chairman Gramm, would you care to comment on that scheme?

Dr. GRAMM. Well, I guess I have a question as to if the CFTC were to allow trading IBM stock on the Chicago Board of Trade, would that be allowed? Is this part of the scheme of anybody?

Mr. BREEDEN. As I understand it, I think it's fairly simple. The question of whether any individual regulator could authorize a type of product, whether he's a bank regulator, a securities regula-

tor, or a commodities regulator, would be governed by the law applicable to banking, securities, or commodities. And so, if the Commodity Exchange Act authorized the listing of a certain type of product on a futures exchange and the CFTC voted to so list that product or authorize it, then it would trade under the CEA.

If, on the other hand, the Securities and Exchange Commission reached a determination that the securities laws authorized the trading of a different type of product on a securities exchange, we would vote to list that on a securities exchange, and that's where it would trade, under those laws.

If a banking regulator decided that a swap was consistent with the Federal Reserve Act or the Federal Deposit Insurance Act, they would authorize that, and we wouldn't have then cross-litigation brought by the other industries saying, "Ah, you've crossed into our turf and you can't do that. That's our monopoly, and you can't trade in that area."

Dr. GRAMM. Excuse me, Senator. I think it probably would be best if we saw some of the legislation because I am not sure exactly what the scheme would be, and I have a lot of questions based on that.

Senator BOND. I think I need to do a little more beyond this particular hearing.

Dr. GRAMM. But I would point out, though, that with respect to swaps and other hybrid instruments, that the Commission has a record over the last 4 years of trying to clarify the regulations and has not sought to regulate them on an exchange pursuant to our regulations. In fact, we have recognized the existence of other regulators and stepped away from some of these instruments. So there hasn't been a problem that has been caused that this jurisdictional change would address.

Mr. BREEDEN. Senator, if I might add just one very brief correction to that. The problem is not necessarily the actions of the CFTC, although their rulemakings have created great doubt in the minds of some securities and banking institutions.

The problem, under the exclusivity clause, is that it is not necessarily the CFTC that challenges the product, it is the private exchanges. And I would be happy to send you a list of numerous cases of litigation brought by the Chicago Board of Trade and the Chicago Mercantile Exchange, not the CFTC, trying to stop products from trading in competition with them. That is the problem.

We really need to get to the point where we are like our competitors, the French, the Japanese, the Europeans, and other countries. When they think up a new product, they take it into the marketplace. They don't go to the courthouse and spend 4 years litigating over it.

Senator BOND. Let me ask you to focus on the question that has been raised by some about the problems of having dual regulation. The two groups of regulators, one CFTC and one SEC, both regulating on one floor, and the possible costs that this might engender for some of the smallest exchanges. Do you see that to be a problem, and how big a problem, and what can be done about it?

Mr. BREEDEN. Well, sir, I am always concerned about anything in our regulatory programs that creates costs, and I think all the programs across the board, our own included, need to be structured

with a careful eye to how we try to minimize unnecessary regulatory costs, excepting that sometimes there are jobs that need to be done and sometimes those do involve expenses for regulated firms.

I don't think that the system that has been proposed would create any serious confusion, as has been suggested, or any substantial pyramiding of costs, as has also been suggested. In fact, there are numerous examples today of something very similar. There are persons who are licensed to trade an agricultural commodity who are not licensed to trade an index future or other type of financial future. There are different rules, even of the CFTC, governing the different exchanges and different types of trading. So there is nothing unusual per se about that. Even today the New York Stock Exchange, for example, has a related separate futures exchange. It operates under the rules of the CFTC, while the New York Stock Exchange parent operates under the rules of the SEC.

These kinds of distinctions, where we have similar rules but perhaps with some variations between the trading of one product and another, is something that we have other examples of and could do consistently in the future.

Under the banking laws we have three separate agencies that enforce some of the statutes, and that has really proved to be a fairly effective system, not without some areas which perhaps could be streamlined.

Senator BOND. One question on which I would like all of you to comment. Secretary Glauber, you mentioned that the major problem was regulatory inability to deal with various activities which may be improper and might utilize two different markets, one the physicals and the other the futures. Why can't the SEC and the CFTC work together like various police agencies, local and State police agencies, the FBI? These agencies have to work together frequently. Why wouldn't the same kind of thing work here? Do you know of any instance where the SEC and CFTC have not worked together?

Mr. GLAUBER. Well, they can, and I believe they do work together. I think the issue is what is the most efficient regulatory system and enforcement system. There are some clear inefficiencies in having two regulators trying to deal in what is effectively trading in one market. We may define it as two because the marketplaces are separate, but the way the participants approach it is that it's one market, and that just is going to lead to regulatory overlap and lack of effective cooperation in some cases.

I don't know enough of the specific experience of the SEC and the CFTC to document those cases for you. But it is striking that there is much more enforcement activity in the individual marketplaces than across those marketplaces. And I think there is something to be learned from that.

Senator BOND. Chairman Breeden.

Mr. BREEDEN. The two agencies work closely together. We need to. That is something that we have always tried to do. And I think at the staff levels both agencies are comprised of highly dedicated professionals who I think are among the greatest resources of this Government in trying to deal with an extremely dynamic, extremely complex system, and to protect the public interest.

We go to bed every night with $3 trillion of the American public's money invested in our markets. That is, in a very real sense, people's pensions, their futures, and we care and our agency and staff care very deeply about making sure that we have the safest possible system to protect the 50 million Americans whose money that is. I know the CFTC feels the same way about protecting the stability of their market and protecting against threats and interruptions to it. Since stocks, options and index futures are in fact one market and there is really not any economic difference between the S&P 500 stocks bought individually and the S&P 500 stocks wrapped up in cellophane bought in a futures contract, our two staffs have to work together because we are both regulating what in that one area is the same thing.

But the problem is, and our suggestion is, that the system would work better if on critical issues, after you've heard all the comment and you've heard all the debate and ultimately a decision has to be reached, one regulator makes the decision. In every foreign market, there is one decisionmaker, and in the United States there are two. We advocate a system in which, at the end of the day when the buck stops somewhere, we get one answer and not two to the problems that confront what is a single marketplace.

Senator BOND. Chairman Gramm, I imagine you would want to comment also.

Dr. GRAMM. First of all, there hasn't been a problem that has been identified in terms of having the SEC and CFTC staff work together on enforcement issues, particularly on intermarket fraud. They have worked well together, not only in this area but also in other fraud areas where we shared information. We have worked cooperatively with regulators and enforcement officials at all levels. There is no reason in theory or in practice for a jurisdictional change to improve that situation.

As you recall, one of the early reasons for an audit trail was to be able to detect and deter intermarket frontrunning, or trading ahead, and that required having the data to be able to sequence the data to see if someone was taking a position ahead of his customers.

What is happening with respect to intermarket frontrunning is that the data systems and the sharing of intermarket data, which has to occur at the exchange level, is indeed occurring. There is now more routine sharing of information that is ongoing under separate regulatory structures, and between the CME and the New York Stock Exchange. That will help us begin the process of determining whether or not intermarket frontrunning is a problem, the extent to which it is a problem, and to bring violators of those laws and regulations to justice. And that is something that has just started at this point in time.

The CBOE is not part of that information sharing program, and the CBOE and the New York Stock Exchange are under one regulator. In fact, the CBOE is the one major exchange that doesn't have a definition of frontrunning that would include futures markets in place that is consistent with the New York Stock Exchange's definition.

So, I don't see a problem here that a jurisdictional fix would address.

And I would also like to put some information into the record with respect to the characterization of international regulators around the world. The structures are not quite as simple as Chairman Breeden has suggested. And I will enter for the record a more detailed description of some of the major international regulatory schemes.

Senator BOND. I would appreciate that, Chairman Gramm.

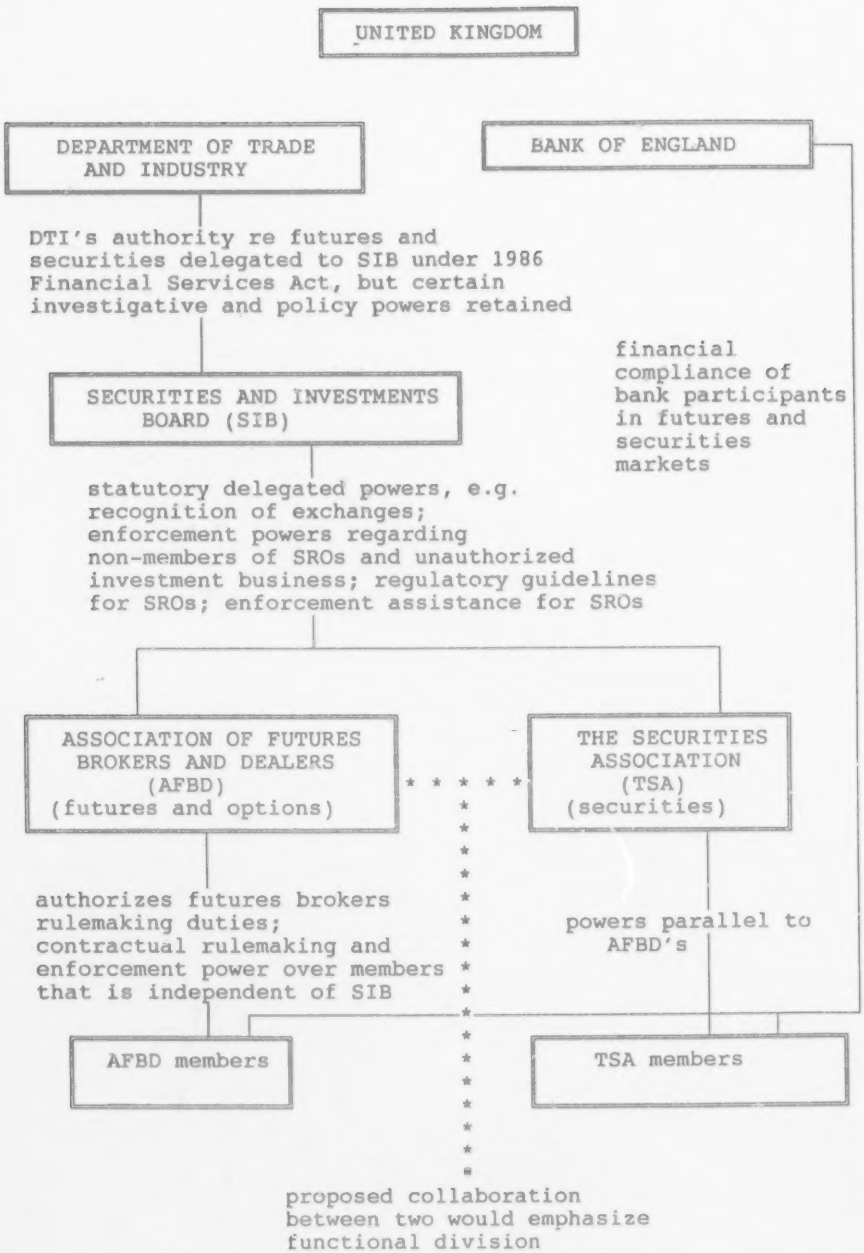
[The information of a description of some of the major international regulatory schemes was subsequently provided and follows:]

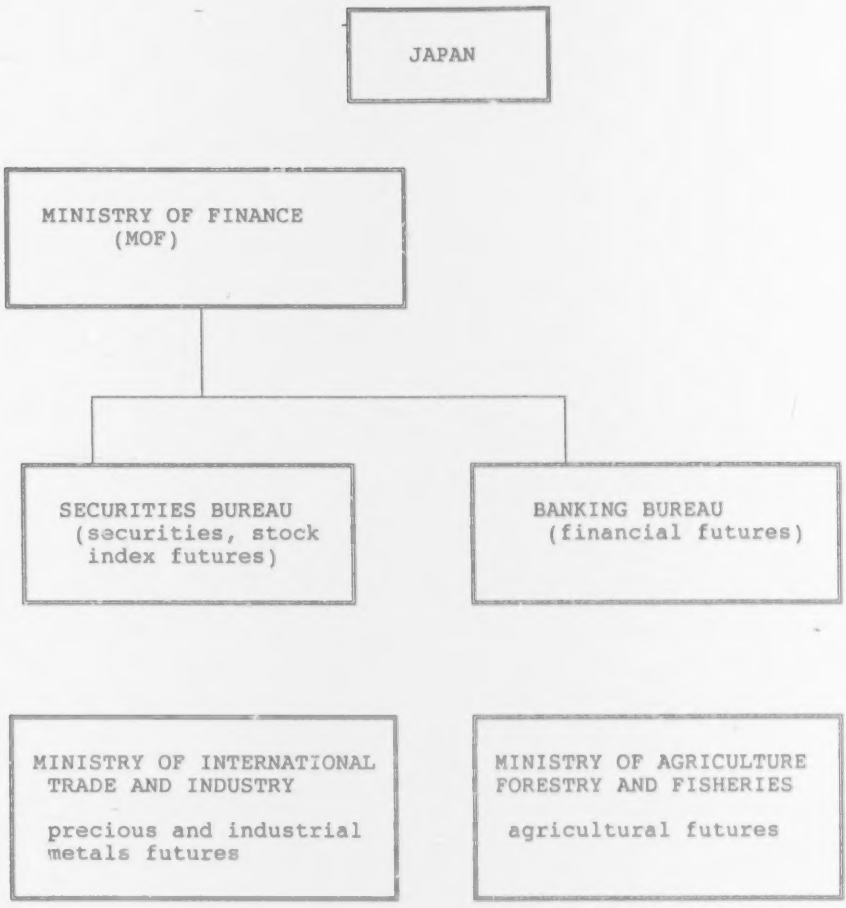
A review of the regulatory systems for futures and securities in countries around the world demonstrates that there is no uniform or preferred regulatory structure for the regulation of securities and futures markets. Each system, even those established in the last few years, is a reflection of unique historical and political realities in each country. The differences between systems are most pronounced in those countries where *both* the securities and the futures markets are large and sophisticated—for example, the United States, the United Kingdom, France and Japan.

To some extent, however, there is a common theme in three of these systems—namely, functional regulation of futures and securities. In these three systems, the organizations responsible for major on-line regulation and enforcement of futures and securities markets are different. This is true whether the organizations are two self-regulatory organizations with statutory authority, as in the U.K. (AFBD and TSA), two quasi-governmental bodies created by statute, as in France (CMT and SBV), or two independent regulatory agencies, as in the United States. In Japan, one Ministry regulates the securities markets, while regulation of futures contracts is divided among two ministries and two Bureaus in a third ministry, according to the nature of the underlying products. Indeed, compared to the systems in place in the United Kingdom, France and Japan, the U.S. system, in which each of the two organizations directly involved in regulation and enforcement has plenary powers in its respective area, is probably the simplest.

INFORMAL COOPERATION

The CFTC has been actively cooperating and sharing information with, and receiving information from, a large number of regulatory, self-regulatory and criminal authorities in matters relating to enforcement, including such authorities in the United Kingdom, France, Japan, Canada, West Germany, Australia, Hong Kong, the Netherlands, Brazil, Switzerland, Austria, Luxembourg and South Africa. Discussions are underway with a number of authorities in these jurisdictions to formalize information sharing arrangements by way of memoranda of understanding or other agreements.


UNITED KINGDOM
DEPARTMENT OF TRADE AND INDUSTRY
BANK OF ENGLAND
DTI's authority re futures and securities delegated to SIB under 1986 Financial Services Act, but certain investigative and policy powers retained
financial compliance of bank participants in futures and securities markets
SECURITIES AND INVESTMENTS BOARD (SIB)
statutory delegated powers, e.g. recognition of exchanges; enforcement powers regarding non-members of SROs and unauthorized investment business; regulatory guidelines for SROs; enforcement assistance for SROs
ASSOCIATION OF FUTURES BROKERS AND DEALERS (AFBD) (futures and options)
THE SECURITIES ASSOCIATION (TSA) (securities)
authorizes futures brokers rulemaking duties; contractual rulemaking and enforcement power over members that is independent of SIB
powers parallel to AFBD's
AFBD members
TSA members
proposed collaboration between two would emphasize functional division


JAPAN
MINISTRY OF FINANCE
(MOF)
SECURITIES BUREAU
(securities, stock
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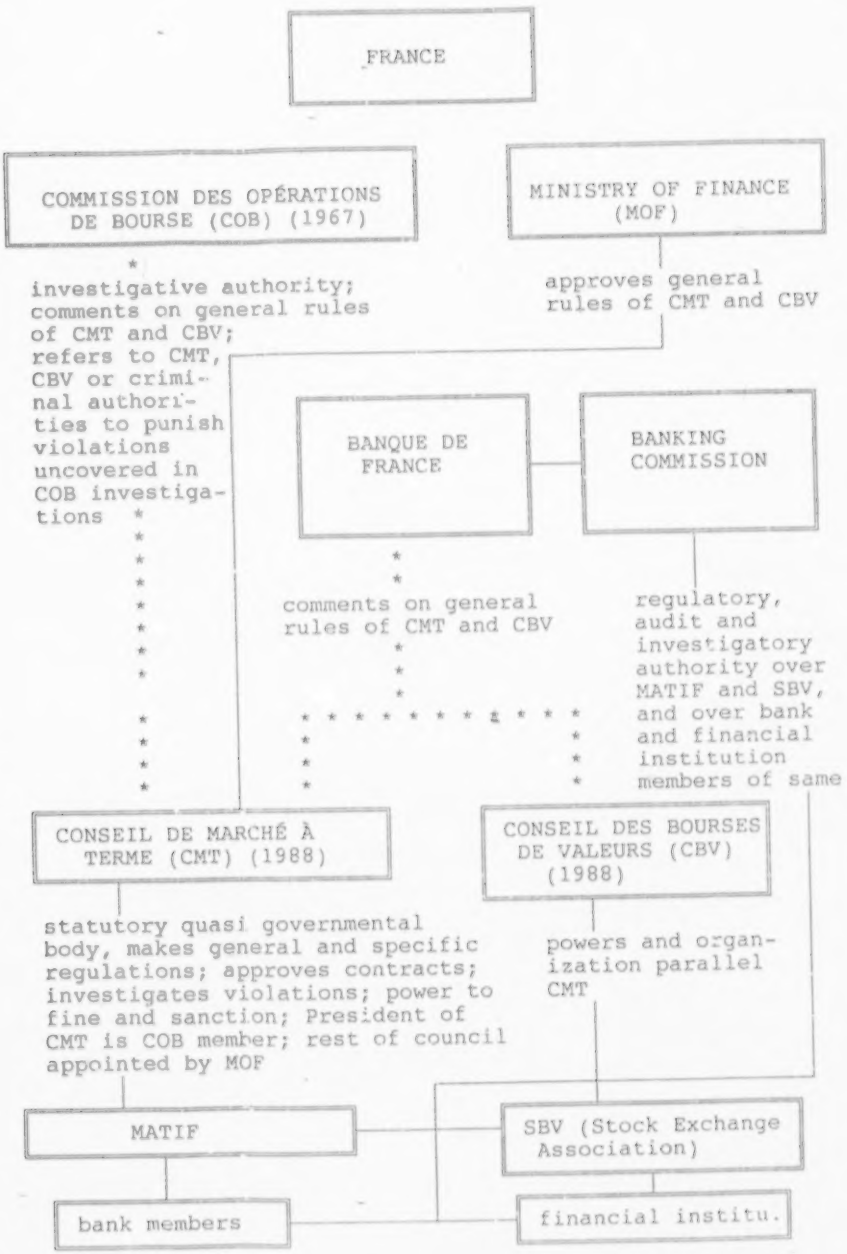
TRADE AND INDUSTRY
precious and industrial
metals futures
MINISTRY OF AGRICULTURE
FORESTRY AND FISHERIES
agricultural futures


FRANCE
COMMISSION DES OPÉRATIONS DE BOURSE (COB) (1967)
MINISTRY OF FINANCE (MOF)
investigative authority; comments on general rules of CMT and CBV; refers to CMT, CBV or criminal authorities to punish violations uncovered in COB investigations
approves general rules of CMT and CBV
BANQUE DE FRANCE
BANKING COMMISSION
comments on general rules of CMT and CBV
regulatory, audit and investigatory authority over MATIF and SBV, and over bank and financial institution members of same
CONSEIL DE MARCHÉ À TERME (CMT) (1988)
CONSEIL DES BOURSES DE VALEURS (CBV) (1988)
statutory quasi governmental body, makes general and specific regulations; approves contracts; investigates violations; power to fine and sanction; President of CMT is COB member; rest of council appointed by MOF
powers and organization parallel CMT
MATIF
SBV (Stock Exchange Association)
bank members
financial institu.

Senator BOND. I have the sneaking suspicion that the chairman is ready to call the end of my questioning.

The CHAIRMAN. Yes, but we will have another go-around, and I will yield to Senator Heflin.

Senator BOND. All right. Thank you.

Senator HEFLIN. Chairman Breeden, in another committee there was a lot of spotlight on American Continental Corporation, Lincoln Savings and Loan, and Charles Keating. An article appeared in Barron's of April 16, 1990, entitled "What Investors Never Knew: Ugly Facts About Charles Keating Were Not Disclosed," by Benjamin J. Stein.[1]

Have you seen this article?

Mr. BREEDEN. I don't recall it in detail. I may have seen it at the time. I know he has written several diatribes in Barron's on various subjects, and I am not sure which species this particular article is.

Senator HEFLIN. Well, it's recent, and I don't know whether anything is true or not. But he makes rather drastic charges about the SEC in this article. Without going into it in detail, I would just point out that he goes into the fact that Keating and the American Continental Corporation, and these others, had charges brought by the Securities and Exchange Commission over a period of time and that in various instances when their prospectus, that there wasn't in it and that no charges were made.

I just would read a little bit here. It says:

"The SEC complaint noted that the extraordinary nature of these transactions had not been revealed in AFC filings, and rather that they had been described as normal loan transactions. In other words, the SEC alleged that Keating and Lindner had been using the funds of a federally insured bank they controlled to make risky loans to help them sell an asset of the parent company."

Then it goes on and the article states: "In 1986 and 1987, ACC filed with the SEC for the sale of $25 million of debentures, as well as for the sale of another $25 million of debentures, and filed registration statements for $200 million of debentures * * *."

He makes rather severe charges. He says, "Yet investors were sold over $200 million of debt instruments that are now worthless, and traded in about $30 million of equity issues that are now worthless, without the SEC's requiring that they be told the most basic facts already in SEC hands about the issuer. To this day the SEC has still not issued a complaint about any Keating-Lincoln omission or lie at all."

He then goes on, and this is rather drastic, "There is no securities law without enforcement of the securities law. Yet in the case of ACC, and in every other case I have studied, the SEC simply does not enforce the laws on the books. This fools investors, makes them think they are protected when they are not; and makes life much easier for crooks. In a word, the kind of failure at law enforcement one sees in ACC/Keating means there is a real question as to whether investors can count on minimum federal law protection."

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[1] See pp. 4–6 for this article.

Now, I am not saying anything is correct in this, but it's a rather drastic charge of dealing with an issue that is certainly in the spotlight today. If you are not familiar with it, I would ask you, and I want to give you an opportunity to reply to it, to look at the article, and if you would reply in writing in regards to the answer of it, if you would.

Mr. BREEDEN. I would be happy to, Senator. But let me, if I could, just respond in brief to some of the charges as you read them. You have me at somewhat of a disadvantage because, as you may know, we have an open investigation of this matter and I cannot discuss that investigation without fear of prejudicing the case against the subjects of that investigation, which I don't wish to do.

Senator HEFLIN. Well, I don't want you to do anything like that.

Mr. BREEDEN. But the notion that the Securities and Exchange Commission doesn't enforce the securities laws is patently absurd. We have collected over $1.3 billion in fines and restitution for defrauded investors in the Boesky, Levine, Drexel, and Milken cases, and I think the record of the Enforcement Division of the Commission in being vigilant and highly effective in rooting out fraud and corruption in the securities markets is outstanding. Mr. Stein, of course, is entitled to his views. But I will say that the SEC has a record second to no agency in this Government in enforcing the laws, and I certainly hope to see that it stays that way.

Senator HEFLIN. All right, sir. This is of some concern in regards to it.

Let me ask you what studies have been conducted to evaluate the cost of the impact upon the U.S. futures market of duplicate regulations by two Federal regulators? Have you all made any study of the evaluation of the cost impact on the futures markets in that regard?

Mr. BREEDEN. Obviously, it is impossible to do a precise calculation because you would have to see the specific terms of the law. It would make a big difference whether you were regulating futures products as securities or under the CEA.

We think, long-run, that the proposals can save enormous amounts of money for the participants in these markets. The major firms trade stocks, options, and futures. It's a single market, and they are in all aspects of it. And today they are forced to comply with two systems, with two sets of requirements for registering and testing personnel, one for the SEC and one for the CFTC. We think there is a potential for savings for the users of these markets if we eliminate a lot of that duplication.

Senator HEFLIN. In the 1987 market break, the option exchanges regulated by the SEC experienced difficulty in opening and reopening their markets and maintaining sufficient liquidity. Now, you probably have made some changes pertaining to that. But in contrast the futures markets were relatively unaffected by the market crash.

Given the SEC's track record, with one derivative market, what confidence should we have that similar problems could not occur if the SEC regulated the stock-index futures?

Mr. BREEDEN. Well, I think you could have very great confidence. As you point out, happily, and I appreciate your doing so, the SEC

has been regulating derivative instruments for 50 years. We have a substantial amount of experience. Our Market Regulation Division has substantial expertise in this area. So I think we have a long-standing track record. I think it's a very good one.

There were other types of problems in the stock-index futures markets both in 1987 and 1989. There was a 6-hour delay in meeting payments from the clearing agencies of well over $1 billion. There were enormous liquidity problems. If you valued the S&P 500 future, the imputed price of the Dow would have fallen to as low as 1400 in the October 1987 market break, whereas in fact the market did not fall that far. The imputed price of the Dow last October, if you took the liquidity of the futures market as a measure, would have been a fall of 250 points. The Dow actually only fell 190 points.

It may be better to defer to Secretary Glauber here, but I think the problems of the illusion of liquidity in the futures markets, liquidity that disappears in a flash when there is a stress on the market, has been extensively documented by the Brady Commission and others and is one of the principal reasons we feel, as a matter of prudence and safety and soundness, that there are some improvements that need to be made in the system.

Senator HEFLIN. I believe my time is up.

Senator BOSCHWITZ. I want to return to Senator Heflin's last question because I didn't understand your answer. He asked if the options market that the SEC oversees was halted or impaired by the volatility of the market and yet the futures market wasn't.

Why should we feel some confidence that the SEC is going to be able to handle such volatility in the future when it apparently hasn't done as well as the CFTC has done in the instances that you seem to cite as evidence for the SEC to take over the whole thing, Chairman Breeden?

Mr. BREEDEN. Senator, I am going to say again, and I am going to keep saying that we have not suggested that the CFTC in any respect has done a bad job in any area of their jurisdiction. We have raised this as a question of the structure of the——

Senator BOSCHWITZ. Let me restate the question: Why should we have confidence that the SEC can do something that it apparently failed to do with the options market when the markets were volatile? Answer the Senator's question, Senator Heflin's question.

Mr. BREEDEN. I tried to answer the Senator's question by saying that there were problems, very substantial problems, in both markets. Those problems were of different types. There certainly were problems in the options market. There have been enormous changes made since then, just as there were problems in the futures markets that have led to changes.

I don't see the connection between the fact that there were problems in both markets. And I am not going to sit here and argue that our markets are perfect and that a 500-point drop in the Dow doesn't put the whole system under enormous pressure. It does. And it is that very pressure that causes us to want to try to strengthen the girders that hold up this bridge, that trillions of dollars of the public's money is invested in.

Senator BOSCHWITZ. May I continue? I have just one or two more questions.

Chairman Breeden, you spoke about the fact that the markets were extremely dynamic and extremely complicated, that we needed the safest possible system, that 50 million Americans involved in pension trusts and so forth were relying upon this system. At the staff level you said, and I quote, "Our two staffs have to work together." And then Chairman Gramm said that there hasn't been any area identified where the staffs have not worked together well.

I just say to you that my fear is that when I see turf battles occurring in Washington, there sometimes is not a continuation of this good working relationship. I trust that both of you will go back—I make this point for the third time—to make sure that the system does remain the safest possible system, that we have a recognition that it is extremely dynamic and extremely complicated, that we know that it is not only you two who must interact but that your staffs must interact.

I hope that you will see to it that in the interaction of the two staffs, that they continue to work in the same smooth operations that have occurred in the past and that this hearing or other hearings on turf battles do not in any way encumber that.

Thank you, Mr. Chairman.

The CHAIRMAN. I have an hour or an hour-and-a-half's worth of questions left. I will submit most of them for the record. I say that seriously. I would ask each of you with responses to questions for the record to try to return the answers as quickly as possible. I was very serious in what I said earlier that I join with the distinguished senior Senator from Indiana, Senator Lugar, and will make every effort to get this bill on the floor under a tight time agreement. And really, the questions that Senator Lugar and I and every Senator have asked here today are in anticipation of the kind of debate we might have.

I mention that because the questions we have asked Secretary Glauber earlier took about 7 weeks. Please don't take that as any kind of personal criticism; it's not. I know the kind of interagency debate that went on within the administration because the innocuous question that Senator Lugar and I asked was not so innocuous. I realize that.

But please answer these questions as quickly as you can. We would like, if we can, to get agreement to bring this issue on the floor.

I would like to look, Chairman Gramm, at the impact on the CFTC of the jurisdiction proposal. Everybody who has testified here has praised you and stood in favor of your confirmation. I think of my favorite course in college, which was Shakespeare, where one of my favorite plays was "Julius Caesar." I hope you don't feel like the funeral scene in "Julius Caesar," because I think they do intend to praise you. [Laughter.]

Dr. GRAMM. I feel the same way myself.

The CHAIRMAN. Not necessarily to bury you. [Laughter.]

Jim Stone, who used to be CFTC Chairman, and was one of the first ones I recall after I joined the committee with oversight in this area, opposes stock-index futures generally. I am just trying to be as fair as I can in setting his position. He opposes stock-index futures in general and he also supports merging CFTC and SEC.

With that on the table, I note that last week he said this about stripping the CFTC of jurisdiction for stock-index futures: "This is an unappealing process, which would leave the CFTC a stepchild agency. The CFTC is underfunded and underappreciated in its current configuration. And matters would be worse if it were so wounded."

Now, that same concern, that the CFTC would be badly weakened by a jurisdiction transfer, appears to be widely shared by the agricultural community, at least based on the letters that I have received.

Dr. Gramm, you are the cop on the beat for the futures markets. Do you agree with Jim Stone's assessment that if you lost jurisdiction for stock-index futures, would it make it more difficult for the CFTC to do its job of policing the other futures markets that would remain within its jurisdiction, to police them against fraud and abuse and manipulation, all the things we want you to do?

Dr. GRAMM. I strongly agree, and that view is also held by a number of the agricultural community because we regulate and monitor futures transactions and we regulate the whole exchange. So we have a small staff, but that staff monitors all futures markets in the same way. If we were to lose some of that staff in order for the SEC to create a mini-CFTC within the SEC, then our staff would be severely hurt.

We are very small, so even if stock-index futures volume may be a small percentage of the volume that we monitor, we have people who monitor not only stock-index futures but all financials—soybeans and wheat, cattle—in the same way. And that is the expertise that we would lose. And it would hamper our ability to monitor those markets.

The CHAIRMAN. Let me then go to Chairman Breeden. You have talked about the transfer and what the SEC would have to do under it. If the transfer were made, I assume that you would have to have an SEC branch for stock-index futures to conduct, obviously, active oversight of the exchanges. I don't think anybody disagrees with this. This SEC branch would have to oversee an expanded registration system. It would have to help bring enforcement cases. It would have to police against floor abuses. It would have to monitor margins, write regulations, and so on.

Chairman Breeden, I would like to get a sense of the level of money and staff that you would be willing to commit to this purpose, assuming stock-index futures were transferred to the SEC. How large a branch would you propose to create inside the SEC to regulate stock-index futures?

Mr. BREEDEN. Well, sir, that would, in part, depend on the scope of the assignment we had and the way the law was written. And I am not trying to be evasive, because it would take far fewer people if we were regulating these products as securities under the Securities Exchange Act of 1934. It would take more people if we were going to do what I suggested we would prefer doing. And it would take a few more people, but it would be less difficult on those exchanges to regulate them under the CEA, as they now are regulated.

The CHAIRMAN. Well, let's take your druthers. Let's say it was done the latter way. What do you think it would take in staff level

and budget? I realize this is a ballpark figure, but, I mean, you must be thinking about it. After all, you and Treasury and others have suggested this shift. So give me some idea.

Mr. BREEDEN. Well, you know, we would of course, long before it actually happened, hope to consult closely with the CFTC to find out how many people are currently doing this work. But, if you took a ballpark number of somewhere in the nature of, say, 100 additional personnel, which would be about one-third of our existing Market Regulation Division, that is certainly a level of resources, particularly if Congress would let us keep part of the $80 million surplus that we will be generating this year, that we could easily absorb and fund.

One of the benefits, frankly, that we have with a much larger agency, is some flexibility. We already have a regional office with 100-plus people in Chicago and in most of the other locations where the CFTC offices are located.

So we think that we could use the existing resources and systems of the agency without an enormous number of additional personnel.

The CHAIRMAN. I understand. And I agree that you do have certain economies of scale, but that what you describe as not an enormous addition represents about 20 percent of what the CFTC now has for their entire operation. I mention this because it goes to the overall idea of where we are, having lowballed the CFTC for all these years.

Let me ask you this, Chairman Breeden, and please, Mr. Secretary and Dr. Gramm, feel free to jump in. I don't want Chairman Breeden to feel he is somehow being singled out because nobody here would want to do that.

Assuming the stock-index futures were transferred to the SEC, whom would you allow to sell stock-index futures contracts to the retail public? I see three possibilities, and tell me if there are others I have missed. One would be brokerage firms that are now registered under the commodity law as futures commission merchants. Second would be firms registered under securities laws as broker/dealers.

Mr. BREEDEN. Well, today it already is both. Merrill Lynch, Shearson, Bear Stearns—all of the major securities firms—are also active participants in the futures markets, and they are registered under both.

Now, the same individuals are not always registered under both systems, but the firms have personnel that are operating in all of these markets. And as I said earlier, that requires those firms to maintain duplicative systems. We would love to move in the direction of having single registration or at least cross-registration of personnel so that whether the original registration was as an FCM or as a broker/dealer, long-run the personnel would be able to give advice to customers on stocks, options, and futures, because there are investment tradeoffs, very direct ones, between those investment products.

The CHAIRMAN. Would you preclude either one? Would you preclude an FCM or a broker/dealer?

Mr. BREEDEN. Preclude them from operating in the other market?

The CHAIRMAN. Preclude them from selling stock-index futures contracts?

Mr. BREEDEN. Well, under the assumption that the law was passed the way we have suggested, the only people who would be allowed to sell stock-index futures would be people who were registered under the Commodity Exchange Act. That would be all the current people who are so registered. Many of the broker/dealer firms, in fact, have personnel under that system. That would continue.

Down the road we would like to see a system in which it would be possible for people registered under either system to operate in these closely linked products.

The CHAIRMAN. Secretary Glauber.

Mr. GLAUBER. I was just going to point out, Mr. Chairman, to the extent that happened, that would open up a vast new sales force to attract customers to deal in these products. And I think the same thing could happen at the institutional level as well. Some institutions which have traditionally just not dealt in the futures market, that are more at home in dealing in the stock market, might under these conditions also deal much more in the futures market. I think it could indeed increase volume.

Dr. GRAMM. I am glad to hear that because during the discussion over the IP's issue, one of the reasons why the Philadelphia Stock Exchange, the main reason why the Philadelphia Stock Exchange proposed the IP's product is they wanted to have a futures-type product that they could sell to the retail customer.

And my response was that then why don't we do a cross-registration of professionals whereby these IP's products could be traded legally as a futures on the Philadelphia Board of Trade, which is a futures subsidiary of the Philadelphia Stock Exchange and then allow that IP's product, which would be legally selling under the futures regulations, to be sold by the retail network of the securities industry.

That is currently allowable under the laws, and it is a proposal that I raised with the SEC staff before the litigation occurred, and it was raised again once the seventh circuit came down with their decision saying that the IP's products are futures. It was a proposal that was made so that these products could be allowed to trade and would not have to be liquidated.

And that was rejected by the SEC. So I am interested in hearing that. I think that is something that could be undertaken at this point in time without a change in the law, without a change in jurisdiction; just sitting down and discussing it.

Mr. BREEDEN. Obviously we could have a long discussion about the IP's product. I was trying to respond to your question about registration. I would very strongly disagree with the characterization by Chairman Gramm that making people trade new products as futures rather than giving them the option to trade them on whichever market they want to trade them, securities or futures, would solve the problem that had been involved in the IP's case.

Dr. GRAMM. But the issue is whether or not securities registered professionals could sell futures products. And that is something that is a regulatory issue that just coordination could solve and would not take a change in the law itself. And that is the issue.

Mr. BREEDEN. The bigger point, I think, a point which Secretary Brady has emphasized again and again and which lies at the heart of the decision of the Bush administration to propose this legislation, is that stocks, options, and stock-index futures comprise one market. Whether you buy the S&P 500 directly on the New York Stock Exchange or through a futures contract on the Chicago Mercantile Exchange, you are dealing with the same economic reality. The firms, by and large, will reflect that, because they are in all of these markets.

The CHAIRMAN. They are what?

Mr. BREEDEN. They are in all of these markets.

The CHAIRMAN. Oh. In them.

Mr. BREEDEN. They have professionals who are trading at any given moment in time, stocks, options, and futures. In every other country with which we compete, there are much more closely unified systems. While there are different SRO's and there are some different technicalities in all the other countries, at the top of the decision chain is an agency, a single agency, that can resolve differences to try to make the job of competing in this single market the most efficient possible. And we think that that change would be an improvement.

The CHAIRMAN. Of course, some have argued the fact that there isn't a single agency doing it in itself has brought about some of the innovation. There has been more competition and innovation. I realize you can get arguments both ways on this, but I just didn't want the record not to note that.

Chairman Breeden.

Mr. BREEDEN. Yes, sir, I agree. That is why, with all due respect to Senator Boschwitz, I would suggest that we not paint this as a turf question, but one where reasonable people can differ for other reasons. There are reasons why some people, as Chairman Greenspan tried to indicate, who prefer a market in which there are a multiplicity of regulators, a large number of regulators, and there are other good reasons why some people would choose to have somewhat fewer regulators.

What is involved is a serious issue of the organization and the structure of the regulatory system and how best to achieve a balance of two factors: competition, which is vital to our markets, and also safety and stability, which is also vital. We have seen what happens when we do not pay careful attention to either one of those factors.

Reasonable people can differ on how to structure the system, but we support the administration's views that a change would help improve the system, and we fully respect all those who disagree with that proposition.

The CHAIRMAN. Thank you.

Anybody else?

Dr. GRAMM. Senator Leahy.

The CHAIRMAN. Dr. Gramm.

Dr. GRAMM. There were a number of issues that were raised earlier on in this whole discussion, and if you would permit me to enter some other information into the record, because I do believe that some of these issues should not be left open.

First of all, I take exception to Under Secretary Glauber's characterization of the agricultural community's views on the jurisdictional issue. And I think that probably all of us would be loath to characterize their views on anything, but they have spoken for themselves. I want to put into the record not only the letter from the Farm Bureau but also the letter signed by some 18 agricultural organizations that oppose transferring of jurisdiction and the concerns that they raise about the impact on the agency.

[The letters of American Farm Bureau and 18 agricultural organizations regarding jurisdiction were subsequently provided and follow:]

MARCH 27, 1990.

DEAR CHAIRMAN GRAMM: As representatives of all segments of U.S. agriculture, we are writing to express our deep concern with the jurisdictional dispute between the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC). In recent weeks, some have asserted that the SEC, not the CFTC, should have jurisdiction over some financial futures contracts, most notably stock-index futures. We believe this could ultimately jeopardize agricultural futures.

Why are we as agricultural groups worried about stock-index futures? Because the CFTC regulates exchanges, not just contracts. Agricultural and financial futures are traded on the same trading floors, subject to the same rules, by the same people. Dual agency jurisdiction over futures exchanges, under two different laws, would be a prescription for regulatory chaos.

We support a strong, independent CFTC with exclusive jurisdiction over futures contracts. A strong CFTC would be strengthened even more under the Senate's pending reauthorization legislation.

We vigorously oppose weakening the CFTC by splitting-off some of its jurisdiction. We are equally opposed to the idea of making the CFTC a division of the SEC. Such a combination would be unworkable because the SEC has no experience in agricultural futures or their regulation. The SEC would undoubtedly seek to superimpose its view of stock market regulation on futures markets. Although futures markets have a 140-year tradition of providing efficient price discovery and hedging mechanisms, these are roles and functions that are fundamentally different from the markets the SEC now oversees. For example, a recent NEW YORK TIMES article quotes SEC Commissioner Edward Fleischman as saying, "We really don't understand those markets, it is a different world. You tell me what we would do differently. I would venture to say nothing."

The efficient, fair pricing of agricultural products would inevitably suffer under a change in jurisdictional authority. We should not leave the impression we always agree with the CFTC, but we value the expertise developed under current oversight authority during nearly 70 years of futures market regulation. For these reasons, we strongly urge Congress to maintain an independent CFTC.

Sincerely,

American Cotton Shippers Association; American Farm Bureau Federation; American Oat Association; American Soybean Association; Millers' National Federation; National Association of Wheat Growers; National Cattlemen's Association; National Corn Growers Association; National Cotton Council; National Council of Farmer Cooperatives; National Farmers Organization; National Farmers Union; National Grain and Feed Association; National Grain Sorghum Producers Assoc.; National Grain Trade Council; National Grange; National Pork Producers Council; and North American Export Grain Assoc.

AMERICAN FARM BUREAU FEDERATION,
PARK RIDGE, IL AND WASHINGTON, DC,
April 6, 1990.

Mr. PRESIDENT,
The White House,
Washington, D.C. 20500.

DEAR MR. PRESIDENT: The American Farm Bureau Federation (AFBF) would like to submit comments regarding the current discussions of the role of the Commodity

Futures Trading Commission (CFTC). AFBF was actively involved in the process in 1974 when Congress created the CFTC. AFBF strongly believed then and continues to believe that CFTC regulation of agricultural futures and options trading is an essential element of a mechanism to market farm commodities.

Farmers routinely face two distinct types of risk exposure. These are yield risk and price risk. Weather is the predominant component of yield risk and is largely beyond the control of the farmer. Although a good yield is an essential element of a price and quantity relationship that produces an adequate total revenue, it is clearly not enough. Quite simply, a great year farming can be wiped out by a poor day of marketing.

Farmers are essentially price takers. As individuals, they have limited control over the price they receive. The commodity futures markets offer farmers an opportunity to price their crops and livestock up to a year or more in advance of the time they will be physically marketed. Futures contracts are the driving force of price risk management. When a farmer enters into a forward contract with a local grain dealer or elevator, the ability of that enterprise to offer a forward contract is dependent on the ability to transfer this risk to someone through a futures contract.

Futures contracts must be designed to meet the needs of farmers and must be based on a clear understanding of production factors, cash markets and producer needs. Agricultural input and oversight, as guaranteed by CFTC regulation, and review by the agricultural committees in Congress is essential. Diluting or eliminating CFTC authority would threaten the long-term availability of an essential agricultural risk management tool.

The current discussion of the differing margin requirements between stocks and commodity futures contracts indicates that many of those involved in the debate are unaware of the nature of farm producers' use of futures contracts. Forcing commodity hedgers to put up additional margin requirements would increase the cost of farmer hedging. Without the agricultural expertise within the agricultural oversight committees in Congress and in the CFTC itself, there will be no framework to ensure that proposals like increased margins for commodity futures are properly evaluated.

Other futures markets currently surpass the commodity futures in terms of volume. While it would be easy through a reorganization to create a situation where size determines emphasis, commodity futures markets remain an essential component of modern agriculture. Their size relative to other markets is not important to producers who depend on hedging techniques to transfer price risk. Commodity futures market regulation by CFTC includes oversight by the Agricultural Advisory Committee and analysis by staff agricultural economists. The commitment at CFTC is for workable, responsive commodity futures markets regardless of the relative volumes of trading activity. Separating the authority over commodity and financial futures markets would isolate CFTC and undoubtedly dilute the expertise they currently have. If the regulation of financial futures is deemed inadequate, CFTC resources should be expanded. Any attempts to lessen CFTC authority and credibility will diminish the use and effectiveness of futures markets for agricultural producers.

The American Farm Bureau Federation has always supported efforts to improve the CFTC. However, as we did in 1974, we strongly support effective regulatory authority by CFTC. Commodity futures markets are unique markets based on the supply of and demand for physical commodities. Regulation of these markets must be by an agency that has expertise in agriculture.

Sincerely,

DEAN R. KLECKNER,
President.

Dr. GRAMM. I also take issue with the point that we have been distracted from our regulatory responsibilities. I think, with all due respect to our hardworking staff, probably what has been neglected are their family responsibilities. But at any rate, we have been promulgating an enormous number of rules and reform regulations as we feel are necessary.

And, Under Secretary Glauber, I have been the one who has been the most aggressive with respect to making sure that the Working Group keeps addressing the issue of coordinated circuit breakers, as you well know.

The third area is the area of clearing and settlement. And I am quite concerned that we have a new version of what happened in 1987 and the stock market break, not only about what actually happened on the New York Stock Exchange and the options exchanges but also with respect to clearing and settlement.

Let me just summarize some comments. The Brady Commission found that, "A substantial number of New York Stock Exchange specialists appear not to have been a significant force in counterbalancing market trends. There were many opening prices that were set by specialists that were grossly inaccurate. Marketmaking performance had deteriorated in the over-the-counter market," et cetera, et cetera.

With respect to clearing and settlement, I would like to enter some information into the record, that for the futures markets, the performance in clearing and settlement far exceeded the securities markets, that all clearing members were paid within the legal timeframe.

[The information pertaining to performance of clearing and settlement systems in commodities and securities markets follows:]

• The performance of the futures clearing organizations during October 1987 and October 1989 provides no basis for a lack of confidence in the futures markets. The principal stock-index futures market, the CME, opened for trading on time on October 20, 1987, and all clearing members were paid within the legal timeframe, that is in "same day funds," although it is true that payments to two clearing members occurred later than usual. The problem was largely caused by the fact that settlement banks did not receive accurate instruction sheets at the usual hour because certain non-cash intra-day variation payments made on October 19, 1987, were not accommodated by existing software and therefore were not reflected in the October 20 variation calculations. In addition, the Fedwire system was apparently subject to volume-induced delays on the morning of October 20. Intra-day variation payments and collections have since been made routine, the applicable software has been modified, and delayed payment problems have not recurred. Indeed, market participants have informed us that making intra-day variation payments and collections to and from the clearing organization by clearing members a routine practice is one of the single greatest improvements in clearance and settlement processes since October 1987. Intra-day payment and collection of margin serve to reduce the burdens imposed upon the settlement system by concentrated payment flows at daily morning settlements. We also note that in addition to the fact that all payments were made by the CME on October 20 in same day funds, standing original margin on deposit at the CME exceeded by billions of dollars the variation margin payments made during October 1987.

• The CME's payment record on October 20, 1987, might be usefully contrasted with that of the stock options clearing organization, the Options Clearing Corporation (OCC). OCC made late payments to *all* of its clearing members on that date, even though OCC's payments are due later in the trading day than CME's payments because of OCC's midmorning settlement. In addition, three National Securities Clearing Corporation (NSCC) clearing members, including one that was also an OCC clearing member, defaulted or withdrew from the clearing organization or depository membership. One of those members caused a $400,000 loss to NSCC.

• The effectiveness of clearance and settlement processes in the futures markets was demonstrated again during October 1989. Clearing and settlement systems functioned effectively to match trades and to settle margin payments on an intra-day basis as well as at daily morning settlements. The futures exchanges reported no defaults or delays in the payment of margin by their clearing members. No futures commission merchant (FCM) failed. Prior to the opening of trading on Monday, October 16, the CME had effected all variation margin settlements representing profits and losses from Friday, October 13 trading activity, a total of $848,315,710. This included margin collected in two intra-day margin calls made during the afternoon of October 13. The CME paid to its clearing members variation margin in intra-day settlements on October 13 of $105,610,000 and $354,360,000. By the end of the day on October 13, the CME had collected approximately $600 million and paid out approxi-

mately $460 million of a total of nearly $850 million in variation payments.[2] As a result, more than half of the total settlement variation for the day was in the CME clearing members' bank accounts prior to the close of the banking system on October 13. The Board of Trade Clearing Corporation also reported that margin settlements on October 13 and 16 proceeded smoothly.

Dr. GRAMM. There were a total of 90 clearing members that were paid—it is true that there were 2 of these 90 clearing members who received payments that were later than normal for an administrative reason. But they were still within the legal timeframe. And the reason why they were later than normal was that the settlement banks had not received accurate instruction sheets at the usual hour with respect to intraday variation payments. And that has since been cleared up.

The claims that clearance and settlement processes would be better regulated and coordinated by a single regulator are refuted by the October 1987 experience. In fact, under the OCC all clearing members on that date received late payments, and on the NSCC, which is the National Securities Clearing Corporations, three clearing members defaulted or had to withdraw their depository memberships.

So I think we should look at the record again and review some of the studies, including the Brady Commission study, as to the performance of these markets in October. I think it is common knowledge among international futures and securities regulators that the futures-style clearing and settlement system is far superior to that of the securities side.

With respect to the stock market decline that Secretary Glauber mentioned, the 6 percent decline, there are at least 13 other days where the stock market declined more than 6 percent since 1930. And as usual, it is difficult to relate such drops to news events.

Finally, with respect to foreign regulators setting futures margins, in fact in all countries the futures margins are set at the exchange level, and while there might be some oversight, it is very limited. And as you know, we have limited oversight in the setting of futures margins.

And a Japanese Embassy official related to me that even in Japan they do not have regulatory day-to-day oversight of futures margins for stock-index futures in Japan. So I would like to include that in the record.

[The information on margin setting by foreign regulators was subsequently supplied for the record and follows:]

Question. Do foreign regulators set margins? How does margin setting work in foreign markets?

Answer:

—On the major futures markets in the world—United States, Japanese, British and French—margin levels for products traded on the exchanges are set by the exchanges.

—In Japan, customer margin levels are set by the exchanges subject to minimum levels set by Ministerial Ordinance based on Article 132 of the Securities and

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[2] If the intra-day margin call results in a variation payment due from a clearing member of an amount in excess of $500,000, the CME Clearing House requires payment by a clearing member of the full amount due. However, the CME Clearing House releases on an intra-day basis only 90 percent of any amount due to a clearing member that exceeds $500,000, and any such amount due must be requested by the clearing member. Accordingly, the amount collected by the Clearing House tends to exceed the amount paid out by the Clearing House on an intra-day basis.

Exchange Law. At the present time, exchange margin levels are the same as the minimum levels set by Ministerial Ordinance. Margin levels for members are not subject to the Ministerial Ordinance.

—In the United Kingdom, margin levels for individual futures contracts are set by the exchanges. Neither the Financial Services Act nor the Securities and Investments Board regulates margin levels on futures.

—In France, the futures exchanges, subject to the general supervision of the Conseil du Marche a Terme, a legislatively created professional body, set margin levels for products traded on those exchanges.

—The Commission is unaware of any futures market with significant volume whose margin levels are set by governmental authorities.

Dr. GRAMM. And finally, for Senator Boschwitz, on jurisdictional fights: We didn't pick this jurisdictional fight. It has occurred in the past, and we feel a little like the younger brother who every once in a while gets punched out by the older brother who then stands back and says, "This violence must stop." We did not pick this jurisdictional fight. And I agree that I would like it to end as well.

The CHAIRMAN. Thank you.

I will keep the record open to the end of the week if anybody wishes to add something further. Or if at 3 tomorrow morning any of you wake up and think of something you should have said, don't call me. The record will be open. [Laughter.]

I always worry about anyone that does that with a listed home phone number. But don't call.

Mr. BREEDEN. Senator Leahy, if I could just intervene quickly so I don't have to call you. I am just appreciating Chairman Gramm's sentiments as to how they feel and like the younger brother. I sometimes feel like the kids who have to go through the debate of saying, "My daddy is smarter than your daddy." And I think there is an element of that sometimes because these are competitive systems. There are rivalries out there in the marketplace. Some of those rivalries do get reflected in our agencies.

But I know that it is Chairman Gramm's intention and my own and Secretary Brady's that we try to focus on doing the best job we can for both markets, producing the strongest possible system, the best job for the public. That's who sends us here, and that is whom ultimately we have to be accountable to.

Mr. GLAUBER. Mr. Chairman, without extending needlessly an already long hearing.

The CHAIRMAN. Take all the time you want. You have been very patient.

Mr. GLAUBER. Thank you, sir. Just a couple of brief points.

First, let me confirm that Chairman Gramm has been a very active participant in the Working Group and indeed, on the particular issue of circuit breakers, has brought that issue back to us. We have met at the staff level once, and we will meet at the principals level in the near future.

On the issue of the amount of money that was late arriving from the clearinghouses. It was later than normal. It was about 6 hours later than normal. It was $1.5 billion. It was a disconcerting amount of money. We viewed it, when we studied it in 1987, as bringing us very close to the edge.

Finally, on the statement I made in my written testimony on the number of down days prior to 1982, I believe the numbers in that

testimony are correct. But in any case, it is something we can settle because it's factual.

The CHAIRMAN. I thank you all, and also Chairman Greenspan. I think you have all been very patient. I appreciate your responses and the candidness of your responses to all the Senators.

Thank you.

[Whereupon, at 6:15 p.m., the committee was adjourned, subject to the call of the Chair.]

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